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Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

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SECURITIES REGULATION

Efforts to Detect, Investigate, and Deter Insider Trading

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The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

This report discusses efforts to detect, investigate, and deter insider trading. The report was developed in response to a request made during hearings before your Subcommittee.

As agreed with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this report. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Assistant Comptroller General

Purpose

Federal investigations have uncovered intricate insider trading schemes in which individuals were found to have accumulated millions of dollars in illicit profits over many years before being caught. Responding to these revelations, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce held hearings on insider trading in December 1986. During testimony, GAO agreed to review the approaches used to deal with insider trading and identify alternatives that might lead to improved detection, investigation, and prosecution.

Background

The legitimate gathering, communication, and use of information for trading and investment decisions is essential to the efficient operation of the Nation's securities markets. When persons buy or sell securities on the basis of information not generally available to the public, that is, engage in insider trading, investor confidence in market fairness can be eroded. The Securities Exchange Act of 1934, as amended by the Insider Trading Sanctions Act of 1984 and the Criminal Fine Improvements Act of 1987, provides strong penalties for insider trading. They include suspension or disbarment from the securities industry, disgorgement of profits realized, payment of a penalty of up to 3 times the illicit profits, criminal fines of up to $250,000, and/or jail sentences. (See pp. 13-14.)

The various stock exchanges and the National Association of Securities Dealers, which operate as self-regulatory organizations (SROs), and the Securities and Exchange Commission (SEC) share responsibility for investigating suspected insider trading. The SROs use computers to monitor trading on a daily basis. When the price or volume of a particular stock changes beyond a certain point, the computers flag the trades for analysis. The SROs investigate suspicious trading by obtaining, from their member firms, the names of those who traded. The SROs compare the names with lists of persons known to be "insiders" and take other steps to see if there are ties between the suspicious trades and insiders. (See pp. 14-15 and 27-33.)

The SROs can require that information be provided by, and can discipline, their members and issuers of listed securities only. Therefore, the SROs refer insider trading investigations to SEC since they usually involve persons outside SRO jurisdiction. After further investigation, if the evidence dictates, SEC and the Justice Department can pursue civil and criminal prosecution, respectively.

Results in Brief

Several factors cause the securities markets to be vulnerable to insider trading, and the nature of this violation makes detection and proof unusually difficult. Gathering information faster and strengthening negotiations with other governments to identify persons responsible for suspicious trades would improve the regulators' ability to investigate violations.

Congress is considering a proposal for stronger penalties to deter insider trading. Additional investigative methods, such as payments for useful information, along with changes in the securities laws, such as defining insider trading, may be necessary if the goal is stronger penalties for this violation.

Principal Findings

Markets Are Vulnerable

Even though the insider trading issue has been prominent in recent years and the number of SEC investigations has grown, GAO found no studies showing whether or not the frequency of insider trading has increased. Nonetheless, the large number of corporate events, such as mergers and acquisitions, the large number of individuals with knowledge of those events, and the potential for huge profits illustrate the magnitude of the markets' vulnerability to insider trading. Also, the securities markets have continually grown and expanded, increasing the risk that the violation will occur and complicating attempts to investigate it. (See pp. 20-26).

Many Questionable Trades Identified

The four SROs that GAO visited, accounting for about 90 percent of the total trading volume in all U.S. securities markets, identified about 83,000 business events or anomalous trading patterns that warranted analysis for potential insider trading in calender years 1985 and 1986. Of these situations, 468 prompted an SRO investigation and each resulted in a referral to SEC. SEC opened formal inquiries or investigations for 203, or 43 percent. More than one-half of the 468 did not result in an SEC investigation because the SRO referral was too old; the SRO did not establish an apparent link between suspicious trades and insiders, often due to the jurisdictional limits on SRO data gathering; or because little or no profits were realized.

The SROs have implemented new automated systems and have continually refined their existing systems to improve the detection of suspected insider trading. In addition, SEC and the SROs have taken steps, including holding joint quarterly meetings, to improve their coordination of referrals and investigations. (See pp. 31 and 38.)

Barriers Prevent or Delay Investigations

Major obstacles exist that prevent, or at least delay, the successful investigation of suspected insider trading. Insider trading is a difficult crime to detect, and it is even more difficult to prove. Therefore, SEC and Justice need to develop evidence as quickly as possible, and delays in doing so can jeopardize the government's chances of proving the violation. (See pp. 39-53.)

A key reason for the delays is that much of the gathering and analysis of data used to identify who executed suspicious trades is done manually. SEC recognized the need for timely investigations and referrals and established goals that referrals will average 3 months and that none will exceed 6 months. It recognized, however, that achieving these goals would require automation and began trying to obtain automated data as early as February 1984. In 1987, the New York Stock Exchange, which is taking the lead in this project, contacted 113 broker/dealers for this purpose. By July 1988, only the New York Stock Exchange and the American Stock Exchange were receiving data in automated form, and only 23 of the 113 broker/dealers contacted for this purpose in 1987 were using the proposed automated methods. Also, rule changes proposed by the New York and American Stock Exchanges to require members to submit data in a standard, automated form were approved by SEC in June 1988. However, the date by which broker/dealers must adopt the automated methods is unclear. As of July 1988, the other two SROs that GAO visited had not proposed similar rules changes to SEC. (See pp. 43-49.)

Trading through foreign bank accounts often poses unusual difficulties for SEC. It cannot identify who made trades in which the use of inside information is suspected, except through lengthy and often unsuccessful negotiations. Laws enacted by other countries protect the identity of those who traded. Data provided by SEC indicate that about one-third of the SROs' referrals include one or more suspicious trades made through foreign institutions. (See pp. 49 and 50.)

Agreements between the U.S. and foreign governments to share information provide a basis for requesting records needed in insider trading

investigations. However, the agreements do not always provide an expeditious process for identifying who made suspicious trades. In addition, access agreements are not in effect with some countries that have a large and growing volume of trading in the U.S. markets. (See pp. 51 to 53.)

Problems in Imposing Criminal Sanctions

In 1984, Congress increased the penalties for insider trading, and the Senate Committee on Banking, Housing and Urban Affairs recently completed action on S. 1323, which would provide stronger criminal sanctions, including fines up to $1 million or 10 years' imprisonment. Because of the nature of trading, SEC and Justice face obstacles in obtaining the evidence necessary to pursue either civil or criminal sanctions. Persons trading on inside information generally do not leave evidence that a crime has occurred. SEC and Justice must often use tips from the public and cooperating witnesses to provide the evidence necessary to prove insider trading. (See pp. 55 and 56.)

For example, of the 45 enforcement actions brought in fiscal years 1985 and 1986, informants were instrumental in providing information in 15 cases. The increased use of informants might lead to improved enforcement of the law and to the imposition of stronger penalties. Recognizing this, in February 1986 SEC Commissioners generally viewed positively a program of rewards for persons who provide information leading to successful prosecutions. SEC did not pursue a rewards program because it required new legislation and there were competing priorities for SEC staff time. In May 1987, H.R. 2494 was introduced to authorize SEC to pay for information leading to the detection and prosecution of insider trading. The bill was awaiting consideration by the House Committee on Energy and Commerce as of July 1988. (See pp. 56 to 58.)

Congress and SEC have recognized that imposing criminal sanctions for insider trading under federal securities laws can be difficult because securities laws do not clearly define the behavior constituting insider trading. In December 1987, the Senate Subcommittee on Securities held hearings on S. 1380, a bill proposing a statutory definition. In February 1988, SEC submitted draft legislative language for this bill; as of July 1988, the bill was still in committee. (See pp. 58 to 61.)

Recommendations

Because of the importance of timely information to the detection of insider trading and because it remains unclear when the process will be fully automated, GAO recommends that the SEC Chairman, in conjunction

with the SROs, establish a timetable for automating methods used to identify those who made suspicious trades. SEC should use this timetable to monitor progress to assure that unwarranted delays do not occur.

GAO also recommends that the Chairman strengthen negotiations with other countries for the release of information on suspicious trades executed through foreign financial institutions. The Chairman's actions should include

- establishing a policy that when the new automated methods used to identify those who made suspicious trades become available, any identified patterns of suspicious trading by foreign institutions will be considered in attempts to persuade foreign governments to release the names of the beneficial owners involved; and
- determining the feasibility of routine disclosure by foreign institutions of the size of individual trades made in the U.S. securities markets.

Matters for Congressional Consideration

A major difficulty in the investigation of insider trading is determining whether such actions are occurring. Informants often provide key investigative leads, and the extent that informants should be encouraged to reveal insider trading is a policy matter that Congress should decide. H.R. 2494 would authorize SEC to pay for information leading to the detection and prosecution of insider trading. The Subcommittee should pursue with SEC, the Department of Justice, and other appropriate law enforcement agencies the feasibility of using this technique to identify and prosecute insider traders.

Foreign regulators have told SEC that certain provisions of the Freedom of Information Act inhibit their willingness to cooperate. Therefore, in June 1988, SEC submitted a proposal to Congress recommending the enactment of legislation that would authorize SEC to withhold from disclosure material provided by a foreign country if public disclosure of the material would be contrary to that country's laws. As of July 1988, this proposal was pending.

Agency Comments

Generally, SEC and the four SROs agreed with GAO's findings and the thrust of its conclusions and recommendations.

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Abbreviations

AMEX	American Stock Exchange
ASAP	Automated Search and Match System
CBOE	Chicago Board Options Exchange
DOJ	Department of Justice
FOIA	Freedom of Information Act
GAO	General Accounting Office
ISG	Intermarket Surveillance Group
ITSA	Insider Trading Sanctions Act of 1984
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SIAC	Securities Industry Automation Corporation
SRO	Self-regulatory organization

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Introduction

Federal securities laws were established to promote fairness and thus ensure public confidence in the U.S. securities markets. This confidence is necessary to facilitate capital formation and enhance our Nation's economic growth. Gathering, analyzing, and disseminating adequate, reliable information for trading and investment decisions in a prompt and equitable manner is essential for the markets to operate fairly. But when people communicate or use information not generally available to the public to buy or sell securities, and that information was obtained through misappropriation or used in breach of a duty of confidentiality, the markets' fairness is eroded.

In 1986, two highly publicized insider trading cases created concern about the fairness of the markets. In May 1986, the Securities and Exchange Commission (SEC) filed an action in a U.S. district court against Mr. Dennis Levine and others for insider trading.[1] As a result of this action, Mr. Levine agreed to relinquish $11.6 million in profits obtained from his trading. A few months later, SEC brought action against Mr. Ivan Boesky and others for insider trading, and Mr. Boesky relinquished $50 million in profits and paid a civil penalty of $50 million.[2] Responding to these disclosures, the Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, held hearings on insider trading in December 1986. During those hearings, we agreed to

- examine the regulators' overall approach and programs for dealing with insider trading; and
- identify alternatives that might lead to improved deterrence, detection, investigation, and prosecution.

In a December 1986 hearing held by the House Subcommittee on Oversight and Investigations, we provided a perspective on the complexities of investigating suspected insider trading, including an overview of the New York Stock Exchange's (NYSE) surveillance systems.[3] This report is based on additional work at NYSE as well as work at other organizations.

[1] SEC v. Dennis Levine, et al., 86 Civ. 3726 (RO) (S.D.N.Y.), filed May 12, 1986.

[2] SEC v. Ivan F. Boesky, et al., 86 Civ. 8767 (S.D.N.Y.), filed Nov. 14, 1986.

[3] Statement of William J. Anderson, Assistant Comptroller General for General Government Programs (GAO/T-GGD-87-2, Dec. 11, 1986).

Securities Laws Are Designed to Promote Fairness in the Securities Markets

Insider trading undermines and can destroy the popular belief that the U.S. securities markets are conducted in a fair manner. Securities laws in this country are intended to deter unethical and undesirable practices in the securities markets in order to protect investors, enhance investor confidence in the markets, and ensure the maintenance of fair and honest markets.

A House report[1] that chronicled the debate surrounding the Securities Exchange Act of 1934 illustrated the legislative concern about the fairness and efficiency of the securities market. It stated:

"The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible adjust price. Just as artificial manipulation tends to upset the function of an open market, so the hiding and secreting of important information obstructs the operation of the market as indices of real value."

Some may question whether this theory applies in today's securities markets, where the volume of trading is dominated by large institutions and characterized by the availability of voluminous information and instantaneous communication. The report[2] of the Task Force on Regulation of Insider Trading, completed in July 1985, concluded that the principle is still valid, stating "people will not entrust their resources to a marketplace they don't believe is fair . . ."

Similarly, former SEC Chairman John Shad, testifying in December 1986 before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, stated that "capital formation and our nation's economic growth depend on investor confidence in the fairness and integrity of the securities markets." He expressed concern that insider trading would make investors question this fairness and integrity and therefore be less willing to place their money at risk. During the same hearing, NYSE Chairman John Phelan stated that "insider trading attacks the very heart of America's capital-raising process. And makes all of us potential victims of a greedy few . . ."

Various laws and proposals support the notion that insider trading is a serious crime and that those found guilty should be subjected to severe

[1]H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934).

[2]Report of the Task Force on Regulation of Insider Trading, The Business Lawyer, vol. 41, Nov. 1985, pp. 223-272.

penalties. The Insider Trading Sanctions Act of 1984 (ITSA) provided additional statutory sanctions for use against insiders. Under the act, SEC may seek a civil penalty of up to three times the amount of profit gained or loss avoided as a result of the insider's trading. The act also increased from $10,000 to $100,000 the maximum criminal fine for any violation of the Securities Exchange Act. In 1987, this maximum amount was increased to $250,000 by the Criminal Fine Improvements Act.

Proposals have been made for even stiffer penalties for persons found guilty of the crime. In December 1987, for example, the Senate Committee on Banking, Housing, and Urban Affairs completed action on S. 1323, which states that such persons ". . . shall upon conviction be fined not more than $1,000,000, or imprisoned not more than 10 years, or both."[6]

Regulators Share Market Oversight and Enforcement Responsibilities

Securities are traded on nine exchanges, such as NYSE; through the National Association of Securities Dealers Automated Quotation System (NASDAQ), which is a quotation medium for certain over-the-counter securities; and in the non-NASDAQ over-the-counter securities markets. Each exchange is self-regulated, as is the National Association of Securities Dealers (NASD), which regulates the over-the-counter securities market and all broker/dealers doing securities business with the public. These self-regulatory organizations (SROs) and the securities industry as a whole are overseen at the federal level by SEC.[7]

In line with this concept of self-regulation, the SROs have primary responsibility for the day-to-day surveillance of trading activity. However, they share with the SEC and Department of Justice the responsibility for investigating and prosecuting potential instances of insider trading.

SRO Responsibilities

The SROs monitor trading activity in their markets on a daily basis to detect possible insider trading and other types of violations. They have similar systems and procedures for this purpose. An analysis is initiated when the SROs' systems generate an "alert" that trading is suspicious

[6]As of July 1988, S. 1323 was still on the Senate Legislative Calendar (No. 502).

[7]Detailed descriptions of the securities markets' regulation, including SEC's oversight, were the subject of two prior GAO reports: SECURITIES AND FUTURES: How the Markets Developed and How They Are Regulated (GAO/GGD-86-26, May 15, 1986) and SECURITIES REGULATION: Securities and Exchange Commission Oversight of Self-Regulation (GAO/GGD-86-83, Sep. 30, 1986).

because of unusual changes in the price or volume of shares traded. This may result in an SRO investigation if, upon further analysis, the price or volume surge remains questionable.

As part of their investigations, the SROs request from their member organizations (broker/dealers and their employees) the names of individuals and organizations who traded in advance of a corporate transaction or event. The SRO attempts to establish if there was or may be a match or some link among those trading in the security and those having advance knowledge of a transaction or event. They may identify situations where insiders have improperly traded or where linkages exist between insiders and other traders. SROs are required to enforce compliance of their members and member organizations, namely broker/dealers, with SRO rules and federal securities laws.

The SROs conduct disciplinary hearings and penalize their members when violations of securities laws or SRO rules are found. Some examples of actions or penalties imposed by the SROs for various types of violations include (1) warning letters advising the violator that repetition of the same conduct could lead to further disciplinary action; (2) fines ranging up to $25,000 for each violation for members and up to $100,000 for member organizations; (3) suspension from the use of their market's trading facilities, dealing with other members, and trading as members for a specified period; and (4) expulsion from trading and from SRO membership.

The SROs have no authority to issue investigative subpoenas or to discipline nonmembers. While SRO members may be involved in insider trading, nonmembers, such as persons associated with the company issuing the securities or other persons communicating inside information, are generally involved as well. Therefore, the SROs refer the results of their insider trading investigations to SEC.

SEC Responsibilities

SEC initiates insider trading investigations on the basis of information provided in the SROs' referrals and from various other sources. SEC also investigates potential insider trading and other abuses through its Prevention and Suppression of Fraud Program, which operates out of the Division of Enforcement and regional offices. SEC principally relies on the SROs for daily, real-time surveillance of their markets and subsequent referral of matters involving suspicious trading activity. However, SEC may also detect indications of insider trading from complaints, tips, other investigations, and staff review of business news. While SEC

and the SROs may obtain similar information in their investigations, SEC's jurisdiction is much broader than the SROs'. Section 21(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78 u(b)) empowers SEC to issue subpoenas to obtain sworn testimony and documents from any person or entity within the United States.

SEC oversees the SROs' surveillance activities through its Division of Market Regulation. Division staff periodically examine the detection and investigation capabilities of individual SROs to ensure the adequacy of their programs. SEC has its own Market Information Data System, which can be used to check the accuracy with which the SROs' automated surveillance systems generate alerts. SEC's oversight reviews have prompted changes in SRO procedures and were instrumental in encouraging the SROs to develop better automated trading records to aid investigations.

As provided in Section 21 of the Securities Exchange Act of 1934, as amended, SEC can take action against persons suspected of insider trading. Sanctions sought by SEC are either administrative or civil, or both. Most of these enforcement actions are resolved through settlement rather than litigation. Settlements are court approved and judicially enforceable agreements between SEC and the defendants in which the defendant typically accepts the penalty or sanction without admitting or denying guilt. SEC Commissioners must approve settlement terms in administrative proceedings; for civil proceedings, the Commissioners must authorize settlement terms to be presented to the courts.

Administrative law judges within SEC preside over contested administrative proceedings, while civil matters are heard in a U.S. district court. Administrative sanctions include suspension, revocation, or limitation of a broker/dealer or investment advisor's registration and can be imposed on individuals associated with broker/dealer or investment advisor firms as well. Administrative sanctions cannot, however, be imposed on a person who is neither registered with SEC nor associated (or seeking to become associated) with such a registrant. Civil remedies may consist of injunctions and ancillary relief, such as freezing of assets, disgorgement of illegal profits, and restitution to investors. Since 1984, SEC can also seek treble penalty orders under ITSA.

Department of Justice Responsibilities

When the SEC staff believe that the facts of an insider trading investigation may involve criminal violations of the law, they notify the appropriate U.S. Attorney's office or the Department of Justice (DOJ). The U.S.

Attorney or DOJ can then request access to SEC investigative files to determine whether the facts support investigation and prosecution of the case under his or her jurisdiction. SEC can also formally refer the case to the Attorney General. On many occasions, the SEC's legal, analyst, and accounting professional staff assist the criminal prosecutors.

Insider Trading Enforcement Actions Have Increased

The number of enforcement actions brought by SEC in recent years has increased. According to its records, in the 46-year period from its inception in 1934 through fiscal year 1979, SEC brought only 53 enforcement actions involving insider trading violations. In contrast, SEC brought 177 actions in the 8-year period from fiscal year 1980 through fiscal year 1987, and the number has increased dramatically since 1984, as figure 1.1 shows.

Similarly, the amount of profits disgorged, or relinquished, in fiscal year 1986 far exceeded the 1985 amount. From the 27 insider trading cases in fiscal year 1986, there were $30.2 million[a] in disgorgements, from the 18 cases in fiscal year 1985, there were $2.1 million in disgorgements.

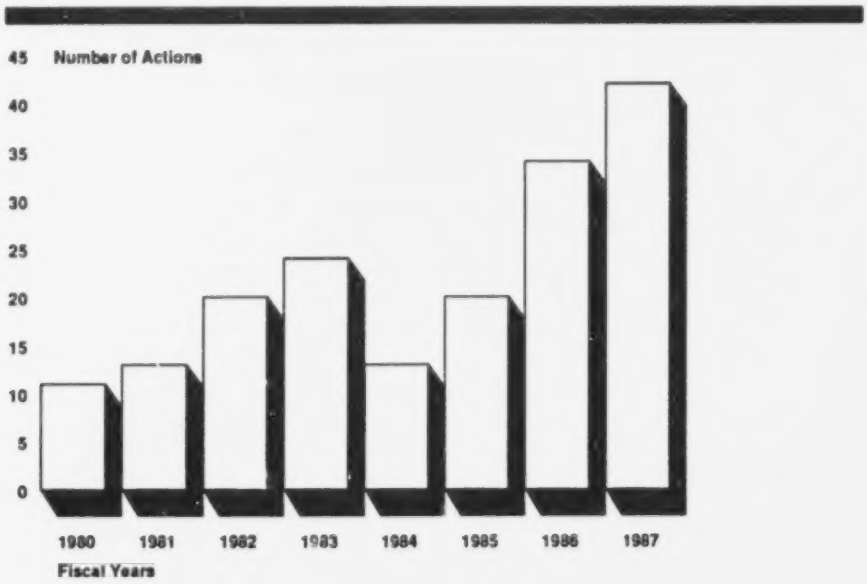
Objective, Scope, and Methodology

The objective of this review was to examine the approach that selected SROs and SEC follow in dealing with insider trading and identify any alternatives that might lead to improved detection, investigation, and prosecution. The review resulted from the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, December 11, 1986, hearing focusing on the surveillance processes of SEC and the NYSE.

Our review was done in accordance with generally accepted government auditing standards and consisted primarily of analyzing testimonial and documentary evidence provided by SROs, SEC, and federal law enforcement agencies. We visited these organizations at varying points and for varying lengths of time from January 1987 to June 1988. SEC, NYSE, NASD, the American Stock Exchange (AMEX) and Chicago Board Options Exchange (CBOE), provided written comments on a draft of this report. These comments are presented and evaluated in chapter 4 and are included in appendixes I through V.

[a]Of this $30.2 million disgorged in fiscal year 1986, $11.6 million resulted from the case involving Mr. Dennis Levine. SEC v. Dennis Levine, et al., 86 Civ. 3726 (RO) (S.D.N.Y.), filed May 12, 1986.

Figure 1.1: Number of Insider Trading Enforcement Actions Brought by SEC in FY 1980 Through FY 1987



To evaluate the SROs' detection and investigation procedures, we selected four SROs for review: NYSE and AMEX in New York City; CBOE in Chicago, Illinois; and NASD in Washington, D.C. These four SROs collectively account for over 90 percent of the total volume in all U.S. securities markets. We interviewed officials, reviewed written procedures, and analyzed data relating to the SROs' insider trading investigations completed in fiscal years 1985 and 1986. We did not independently assess the effectiveness of the SROs' automated surveillance systems used to detect suspicious trades. Rather, we reviewed recent SEC inspection reports that assessed the SROs' surveillance systems and investigation procedures and contained comments on the adequacy of the SROs' systems and procedures for detecting and investigating insider trading and other trading violations.

To assess SEC's handling of insider trading investigations, we worked at SEC headquarters and at its New York and Chicago regional offices. We interviewed staff in the Office of General Counsel, the Divisions of Enforcement and Market Regulation, and the two regional offices. We analyzed data from SEC files summarizing the results of insider trading investigations, reviewed access agreements to foreign bank records, and examined documents concerning the Freedom of Information Act's

(FOIA) impact on SEC investigations. At SEC and the four SROs, we obtained information on recent and planned changes to improve the detection and investigation of suspected insider trading.

To identify alternative approaches and techniques for possible use in investigating insider trading, we interviewed officials at DOJ in Washington, D.C.; and the U.S. Attorneys' offices in Chicago, Washington, D.C., and the southern and eastern districts of New York. We also interviewed officials at the Federal Bureau of Investigation and the Postal Inspectors' offices in Chicago.

Securities Markets Are Vulnerable to Insider Trading

Although the issue of insider trading has become more prominent in recent years and the number of SEC enforcement actions against insider traders has grown, we could find no studies showing that the frequency of abusive insider trading has increased. Because of the nature of insider trading, studies showing the level and trends of insider trading would be difficult, if not impossible, to do. Insider trading is a violation that may not be directly observable or easily proven because it requires showing what someone knew and when they knew it. Also, unlike some other crimes, the victims (other shareholders) may not always realize that they have been harmed.

Nonetheless, the number of corporate events, individuals with knowledge of those events, and the sometimes staggering profits that can be made illustrate the magnitude of the markets' vulnerability to insider trading. These factors, when considered along with the growth and expansion of securities markets in recent years, reinforce the need for a strong program to detect, investigate, and prosecute individuals who have profited from insider trading.

Numerous Corporate Events Provide an Opportunity for Many People to Use Inside Information

Considerable opportunity exists for persons to engage in insider trading. Corporate events that can materially affect stock prices occur daily, and the number of people who have advance knowledge of such events is large.

Many factors can cause a company's stock prices to rise or fall. For example, the prices may rise when a business merger or acquisition attempt is announced, actual earnings are up more than expected, a dividend increase is announced, or a company buys back its own stock. Conversely, the price may fall when certain events occur, such as when a merger or acquisition plan is terminated, actual earnings are less than expected, or an expected dividend payment is not declared. Events occurring entirely outside a company, such as recommendations by financial analysts and writers, can also affect the trading and price of the company's stock.

SEC receives numerous financial reports each year, many of which contain information about material corporate events that, if known prior to public dissemination, could be used as a basis for insider trading.[1]

[1] Although information contained in these reports usually has been made public prior to when the filings are submitted to SEC, we used these filings to indicate the vast amount of existing corporate information that may affect stock prices and be used as a basis for insider trading if the information is material and known prior to public dissemination.

Annual reports (Form 10-K) and quarterly reports (Form 10-Q) contain information about the previous year's or quarter's profits and losses of filing companies, and when made public, this information may affect the company's stock prices. Other statements, namely Form 8-K (the "current report"), disclose unscheduled material events that may affect a company's financial performance and, in turn, its stock prices. In addition to these periodic statements, SEC receives statements describing single corporate events or transactions, such as tender offer filings (Schedules 14D-1 and 14D-9),[2] which may have a material effect on the stock prices of the companies involved. A total of 21,219 companies filed reports with SEC during the 5-year period from 1983 through 1987. As indicated in table 2.1, the total number of filings containing information that, if known prior to public dissemination, could conceivably provide an opportunity for insider trading increased by 38 percent from 45,671 in fiscal year 1983 to 62,838 in fiscal year 1987.

Table 2.1: Summary of Selected Filings for Fiscal Years 1983 and 1987

Type of report filed	Number of filings 1983	1987	Percentage increase
Annual reports	8,832	10,870	23
Quarterly and current reports	32,366	45,033	39
Tender offers and acquisitions	4,473	6,935	55
Total	**45,671**	**62,838**	**38**

Naturally, having access to material information in reports like those discussed above before the information becomes public could prove advantageous. If such material information is used as a basis for trading, one could possibly earn substantial profits while incurring relatively little economic risk.

People in a wide range of occupations have the opportunity to become aware of such events and become involved in insider trading. In addition to corporate executives who have first-hand knowledge of major corporate events, insiders may include investment bankers, lawyers, accountants, or other company employees. Further, others not directly involved in the management of the company, such as broker/dealers; printers; writers for financial publications; and friends, relatives, and associates of any of the above have been subject to SEC enforcement actions in insider trading cases.

[2]A more detailed description of these tender offer filings is contained in our report entitled SECURITIES REGULATION—Hostile Corporate Takeovers: Synopses of Thirty-Two Attempts (GAO/GGD-88-48FS, Mar. 1988).

A large number of people could possibly have access to inside information. The NYSE's Automated Search and Match (ASAM) system illustrates the potential number of individuals who have access to and may be tempted to trade on inside information. NYSE developed ASAM by researching major business publications and directories. This system, which automatically matches automated trade data submissions against the ASAM investigative tree, enables NYSE to quickly determine if suspected insider traders are officers or directors of the same company, members of the same clubs, or residents of the same area. The ASAM data base contains the names of about 500,000 business executives and has been expanded to include names of lawyers, accountants, and investment bankers. While this number exemplifies the large number of individuals having potential access to nonpublic corporate information, it might be understated because it does not include some company employees and other individuals outside the companies who might gain access to material information. On the other hand, at times the number might be overstated because issuers often restrict knowledge of material, nonpublic information to a small group who has a need to know.

The number and occupations of people who have access to inside information can also be illustrated through tender offers. Information about a single tender offer would be known by all or selected corporate officers and directors, certain other employees, and some agents—such as attorneys and accountants—of both the acquiring and target companies. The number of individuals with advance knowledge of the tender offer grows by adding investment bankers and public relations firms and employees of each of these firms who are working on the tender offer. Also, friends, relatives, and associates of any of the people in the categories listed above may be tipped of the upcoming event.

In December 1986, a former Chairman of SEC, testifying before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, commented on two developments that had increased the opportunities for insider trading. He said:

"First, there has been a significant increase in the size and nature of tender offers. Typically, the bidding corporation offers shareholders of the target corporation a premium over the existing market price of their shares. Those with advance knowledge of tender offers can realize profits quickly with negligible risk of loss.

"Second, there has been an increase in the trading of standardized option contracts. The purchase of option contracts, rather than the underlying securities, requires less capital and enables inside traders to maximize their profits. Once a tender offer

or merger becomes public, the market value of options increases by a greater percentage than the stock."

Table 2.1, presented earlier, shows that about 6,000 tender offer and acquisition filings were made in fiscal year 1986, a 34-percent increase over a 3-year period. Considering the number of people who have access to information about each tender offer, numerous opportunities exist for insider trading surrounding tender offer announcements alone.

Significant Profit Opportunities Contribute to Market Vulnerability

Anyone having inside information may be tempted to communicate or use it for trading because the profit potential can be enormous. Profits reportedly made prior to announced business mergers and acquisitions illustrate the incentive to obtain and use information about upcoming events.

Mergerstat Review, published annually by W. T. Grimm & Co., is the most comprehensive source on takeovers of U.S. companies.[3] Using data from the Mergerstat Review for 1985 and 1986, SEC officials estimated that total dollar premiums paid to target shareholders in takeovers of publicly traded U.S. companies between 1981 and 1986 totalled $118.4 billion. However, SEC officials believe this estimate to be understated because increases in stock prices occurring more than 5 days before the initial public announcement are not included.

Reporting on the subject in February 1987,[4] SEC's Office of the Chief Economist said the average trading volume in the stock of a company subject to a merger or acquisition increases as early as 10 days before the public announcement. Volume rises to 3 times the normal 2 to 3 days before the announcement, 5 times normal on the day before, and 20 times normal daily volume on the announcement day. Other studies indicate that prior to public announcements of material financial news, share prices of target companies' stock rise by more than 25 percent.

The studies do not identify specific causes of the increased trading, and the increases could be attributable to a number of factors. Some may be attributable to insider trading, and others could be attributable to legal

[3]This report contains information on the total dollar value paid for common stock of publicly traded U.S. companies involved in takeovers, as well as the average percentage premium paid for those shares, which is measured relative to the market price 5 days prior to the first public announcement of the takeover.

[4]Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?, Office of Chief Economist, SEC, Feb. 1987.

speculation on the basis of rumors or gossip. Some investors and securities analysts try to identify likely takeover candidates and are quick to purchase such shares on rumors or when they perceive better-than-market performance. Others initiate trades on the basis of technical analyses of price and volume movements.

SEC's case experience indicates, nonetheless, that trading ahead of tender offer announcements is a particularly vulnerable area. About one-half of its successful enforcement actions in fiscal years 1985 and 1986 involved trades made before tender offer announcements. Almost all of the trades cited in the cases involving Mr. Dennis Levine and Mr. Ivan Boesky were made just before tender offers, and both accumulated millions of dollars in illicit profits from those trades, which were in violation of the securities laws. For example, the SEC complaint against Ivan Boesky, which describes his insider trading activity, shows that in 8 days surrounding one tender offer announcement, he made about $4 million in profits from the purchase and sale of 377,000 shares of Nabisco Brands, Inc., stock.

Changes in the Securities Markets Contribute to Market Vulnerability

The vulnerability of the U.S. securities markets to insider trading is exacerbated by the growth and expansion of the securities markets coupled with opportunities for concealing the use of inside information. As shown in figures 2.1 and 2.2, the markets have grown dramatically in the past 10 years in terms of the volumes of shares traded and the number of registered broker/dealers.

At the same time, foreign activity in the U.S. securities markets has increased steadily over the last 10 years. Foreign investors' purchases and sales of U.S. equity securities increased from approximately $38 billion throughout 1978 to $359 billion in the first 3 quarters of 1987—an 845-percent increase.

The expansion of the securities markets into a global trading network has enabled investors and securities professionals to develop and use innovative ways to legitimately raise capital on an international basis. At the same time, SEC has found that the increased internationalization has provided the unethical with increased opportunities to avoid detection when violating U.S. securities laws, particularly those that prohibit trading while in possession of inside information.

Figure 2.1: Consolidated Exchange/ NASDAQ Trading Volume Fiscal Years 1978-1987

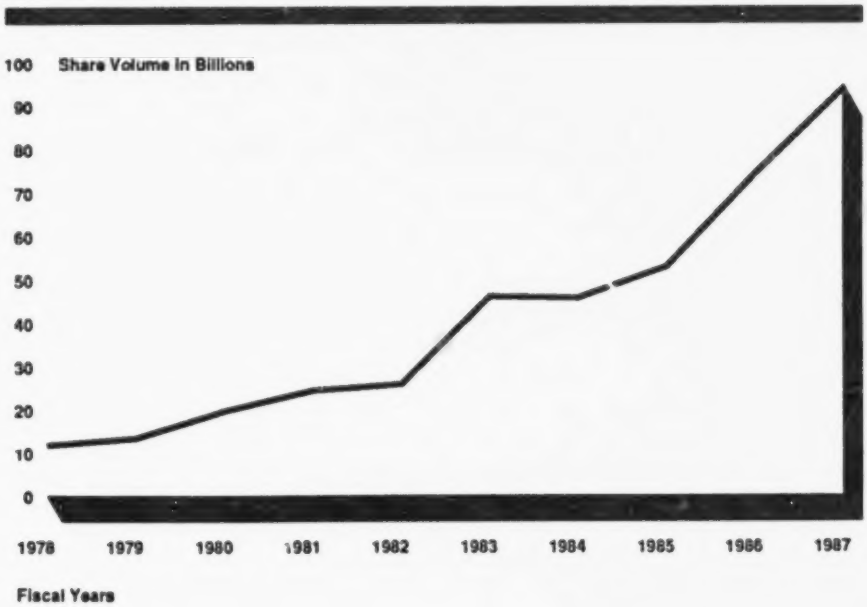


Figure 2.2: Number of Broker/Dealer Registrants Fiscal Years 1978-1987

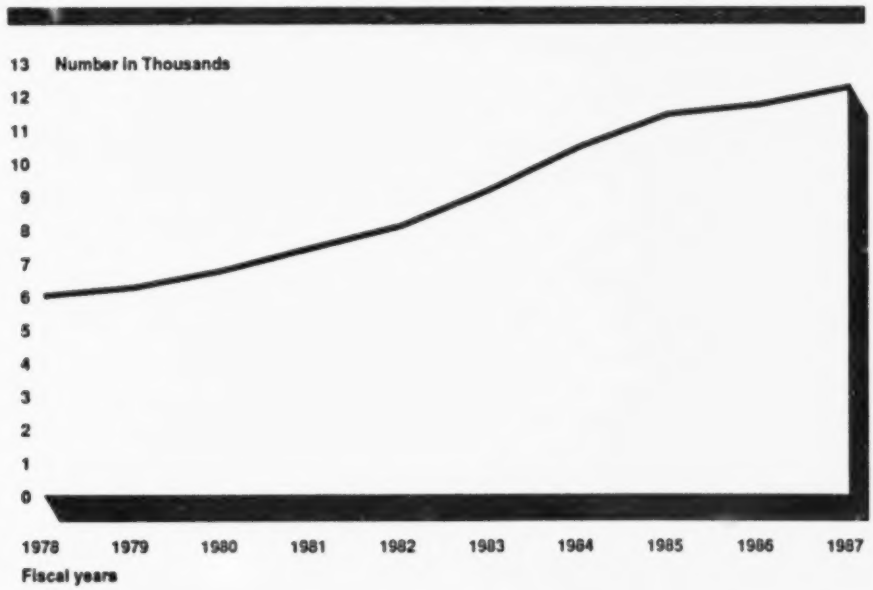
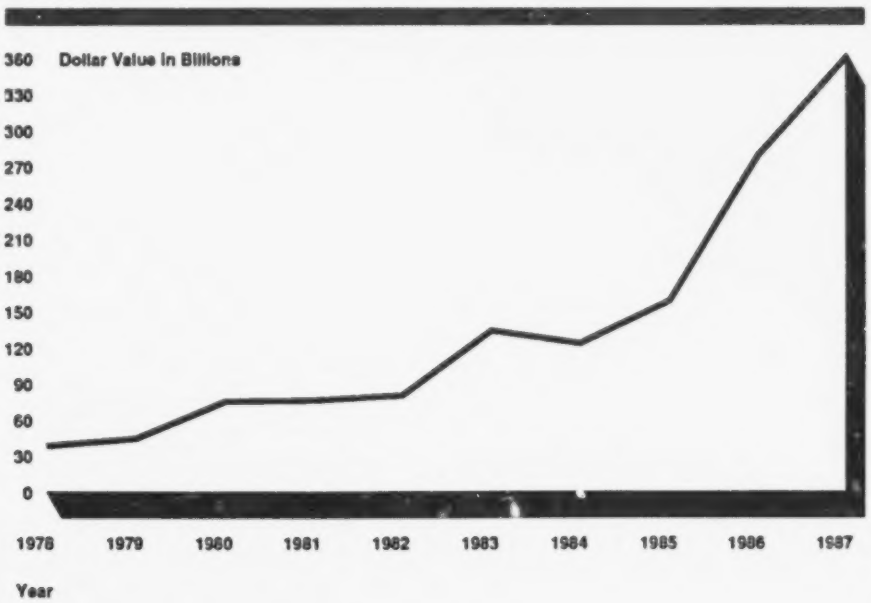


Figure 2.3: Gross Foreign Activity in U.S. Equities (1978 Through 1987)



1987 figure includes first three quarters only.

Those trading on inside information may sometimes try to avoid detection by trading through an account with a foreign institution that conceals their identity, thereby frustrating regulators' attempts to get their names. The federal government's case against Dennis Levine provides a specific illustration of how lucrative trading before mergers and acquisitions can be concealed through foreign accounts. The government's complaint against Mr. Levine detailed the scheme by which the defendant traded, in most instances through a foreign bank, in the stocks of 54 companies that were predominantly involved in mergers or acquisitions. The government's case showed that Mr. Levine accumulated approximately $12.6 million in illicit profits from this insider trading scheme over 5 years, and the government sought the disgorgement of those profits.

Monitoring the Markets and Investigating Insider Trading

Trading before a material corporate event occurs does not necessarily mean that someone used inside information, but such trades may raise questions about who traded and whether they knew about the upcoming event before it became public information. To answer these questions, the SROs routinely monitor stock trading in order to identify those trades that appear unusual and thus require analysis and possible investigation. Because of SEC's broader investigative and enforcement authority, the SROs frequently refer the results of their insider trading investigations to SEC for its consideration.

SROs Continuously Monitor the Markets to Detect Unusual Trading

The SROs monitor securities trading in their markets to identify trades occurring prior to material corporate events and to determine whether an investigation is warranted. Through their analysis and investigation, the SROs identify persons responsible for the trades in question and try to determine whether those trading had access to inside information themselves or had some association with insiders.

Although the processes overlap somewhat, the SROs typically follow three steps in gathering information on possible insider trading before they refer information to SEC. First, using automated systems, the SROs continuously monitor trading to identify unusual changes in the price and/or volume of stock being traded. Second, SRO staff in "stock watch" units routinely conduct analyses, or alert reviews, to find out what caused the price/volume changes identified through the automated systems and to see if an investigation is warranted. Third, SRO staff conduct investigations to obtain additional information and evidence on the trades in question and refer the results to SEC.

Real-Time Monitoring Often Detects Unusual Trading

A key tool in detecting possible insider trading situations are automated systems that monitor, on a "real-time" basis (as it occurs), every securities trade and identify those trades breaking pre-established price and volume parameters.[1] Unusual trading activity, trading occurring outside the parameters, is identified through these systems and marked for further analysis and possible investigation.

[1]Each security has a price parameter break that is determined by an algorithm that establishes an acceptable range of price movement by utilizing a multiday moving average and calculating standard deviations of the movement. When the price moves beyond the established range, an alert or break is generated and recorded. A similar set of parameters is established for each security based on volume activity. Parameters are uniquely developed by each SRO for its respective market.

NYSE, AMEX, and NASD each employ a computerized system to identify suspected insider trading, although their systems differ in how the parameters are established and how the computer programs work. CBOE's approach differs slightly from the other three.

The NYSE and AMEX Stock Watch computers monitor intraday price and volume parameter breaks for every stock traded on their exchanges. These parameters are based on the stock's prior trading activity measured over a number of trading days. For example, NYSE parameters are based on each stock's trading volume and price for the previous 30 days;[2] AMEX parameters are derived from each stock's trading patterns over the past 40 days. NASD's On-Line Surveillance Unit also monitors price and volume parameters for NASDAQ securities.

Parameter breaks by themselves, of course, do not mean that insider trading has occurred or even that an investigation is warranted. Rather, the breaks prompt the SROs to conduct an analysis to see if they can explain why the breaks occurred. Each SRO uses a variety of news services to identify reasons, such as the announcement of a proposed merger or acquisition, for unusual changes in the price or volume of a stock traded. One SRO official explained that a number of events, if they were found to exist during the preliminary investigation of an alert, would alleviate suspicion of any trading violations. These include:

- Trading parameters were broken after a material news announcement concerning the pertinent issuer.
- A large block trade triggered a volume alert but did not affect the price of the stock.
- There was positive or negative publicity prior to the alert; for example, the stock in question was featured in a financial column as a good or bad investment.
- A company in a specific industry classification announces a significant new discovery, and as a result, other companies' stock in that classification may increase in value.

If SRO staff cannot readily explain the parameter breaks, they may contact the exchange personnel on the floor to see if they are aware of any reasons for the unusual trading. For example, NYSE may also contact the

[2]These parameters represent a recent change in NYSE's real-time detection system. Prior to August 1987, NYSE parameters were not stock-specific but instead based on the price of all stock. For example, all $5 stocks had the same price parameters. Also, the previous parameters were for price changes only; no parameters were established for volume changes.

specialist[1] responsible for the stock while NASD may contact the appropriate marketmakers.[2] The staff may contact or request SRO floor or listing representatives to contact the company whose listed stock is showing unusual trading. The purpose of this contact is to determine if the company is aware of any reasons for the stock activity. These contacts are common.

For example, each day AMEX listing representatives contact an average of three to four companies to determine reasons for unusual trading activity. In 1985, AMEX staff contacted companies 856 times for this purpose and 781 times in 1986.[3]

The contact may result in the SRO official encouraging the company to issue a corporate announcement of a proposed merger, acquisition, expansion, new product line, etc., or to make an announcement that the company is unaware of reasons for unusual stock trading. On the basis of discussions with the company and analysis of the trading, the SRO may impose a trading or quotation halt on the stock until all information is disseminated to the public in an effort to prevent insider trading.

To illustrate, the NASD Stock Watch unit noted that from February 4 through March 4, 1985, there were several days of heavier than normal trading in Chomerics, Inc., stock and that during this same period, the price of this stock rose from 20-1/4 to 26-3/4. The Stock Watch unit reported that Chomerics, Inc., had indicated a possible news leak regarding a pending news announcement that W. R. Grace had agreed to acquire Chomerics, Inc. On March 4, 1985, at 12:52 p.m., NASDAQ halted quotations in Chomerics, Inc., at which time the stock was trading at 26-3/4. On March 5, the announcement of the acquisition agreement was made public. NASDAQ reinstated the quotations at 9:13 a.m. on March 6, with the first sale at 29. After the investigation was completed, NASD closed its case on October 29, 1986, and referred the results, identifying 40 customer accounts and 9 brokers, to SEC for review.

[1]A specialist is a member of an exchange who handles transactions on the trading floor for the stocks for which he or she is registered and who has the responsibility to maintain an orderly market in these stocks. The specialist does this by buying or selling a stock on his or her own account when there is a temporary disparity between supply and demand for the stock.

[2]Marketmakers are broker/dealer firms who are willing to buy or sell a given over-the-counter security for their own accounts. Generally, according to NASD's by-laws, there have to be at least two marketmakers for each NASDAQ security. The average NASDAQ security has around 8 marketmakers, and the most active NASDAQ issues have in excess of 40.

[3]As of December 1986, 803 domestic and 49 foreign companies had equity or bond issues on the American Stock Exchange.

In contrast to the SROs who rely on real-time monitoring systems of trading activity, CBOE relies on news events to initiate insider trading investigations. Such news events include takeover rumors, sale of corporate divisions, acquisition of one company by another, and unexpectedly high or low earning reports. To identify possible insider trading, CBOE analysts study trading prior to corporate news. Analysts are assigned to monitor trading of specific industry groups and maintain a historical log of the trading in underlying stock in the option for which they are responsible.

If significant news events are accompanied by significant equity stock price and volume fluctuations, the analyst will also examine the options trading. If this preliminary analysis indicates a suspicion of insider trading, the SRO staff will open an investigation and will contact firms to obtain customer account trading information.

Other Sources of Evidence and Analytical Tools Can Play a Critical Role in Detecting Insider Trading

Parameter breaks at the SROs are just one source of leads for SRO and SEC investigations and can be only a first step toward determining whether insider trading exists. Extensive analysis of the computer-generated data along with data provided by broker/dealers showing who executed suspicious trades is usually necessary before an SRO refers the results of its investigations to SEC. SEC case histories show that even then tips from informants are often critical to identify and prove insider trading.

In addition to their automated systems for real-time monitoring, NYSE, AMEX, and NASD use the results of computer-generated analysis of stock trading over a period of time to detect possible insider trading. This analysis may point out longer term, unusual trading in a particular stock. Such analysis identifies the price or volume creep, which may have been significant over a period of days but yet may not have resulted in a parameter break in an on-line unit where only intraday price and volume changes are monitored.

The SROs have in use or are developing other analytical tools for identifying insider trading. For example, the ASAM system at NYSE enables it to quickly determine if suspected insider traders are officers or directors of the same company, members of the same clubs, or residents of the same area.

In addition to this kind of analysis, the SROs and SEC often receive tips that can lead to an investigation of possible insider trading. A specialist or trading floor official may call regarding out-of-ordinary buying or

selling in a particular stock or option. Company officials may also provide information regarding the buying or selling of stock by a possible insider. The value of tips in detecting possible insider trading situations can be significant. For example, SEC's focus on Mr. Dennis Levine's trades occurred in part as a result of an anonymous tip received by a broker/dealer and forwarded to SEC. The SEC Director of Enforcement said that the tip was critical to the successful completion of this case.

After staff at the SROs have analyzed the unusual trading, subsequent investigation may be required. In these cases, the matter is communicated to other SRO staff for their review and possible investigation, which we discuss later.

Recent Refinements in the SROs' Monitoring Capability

Recent changes in SRO monitoring systems have enhanced the SROs' capability to detect and analyze aberrant trading. These refinements range from the introduction of a complete new computer detection system to automation of news retrieval services.

In August 1987, NYSE replaced its Stock Watch System with a new system called Stock Watch II. SEC Division of Market Regulation officials believe Stock Watch II will substantially improve NYSE's surveillance capability. The prior Stock Watch procedures did not take a stock's volatility or short-term trading volume into account, nor were the parameters adjusted on a regular basis. Stock Watch II is expected to correct these deficiencies and thus improve NYSE's detection of manipulation and insider trading. In addition, NYSE is further developing and refining its ASAM to improve the analysis of suspicious trades.

AMEX has recently introduced refinements to its detection system. Although AMEX's system already had price and volume parameters that were based on the stock's specific performance, it is considering introducing additional flexibility in how these parameters should be established. AMEX also is testing a new automated system for news announcements that will monitor news wires on a real-time basis and automatically alert Stock Watch analysts and floor supervisors of significant news releases of AMEX-listed companies. In addition, AMEX plans to develop a computer system for recording and recalling stock watch alerts.

In addition, NASD planned to change the parameters used in its automated on-line surveillance system. These changes will include the use of historical data, including the standard deviation of the price history of

each respective security. According to NASD officials, these changes will decrease the number of meaningless alerts. NASD is also putting into effect the automated surveillance of non-NASDAQ securities.

Finally, CBOE has also made improvements to its surveillance operations to benefit insider trading inquiries. The improvements, which were implemented in 1987, include a variety of automated reports that assemble and display securities and options information. Formerly, these data had to be compiled manually. As discussed earlier, monitoring corporate news is currently CBOE's primary means of detecting insider trading. However, the exchange is considering whether alternative surveillance approaches, such as the automated volume and price monitoring systems that NYSE uses, can be adapted to options trading.

SRO and SEC Investigations Attempt to Link Suspicious Trading With Insiders

SEC and the SROs use several investigative techniques to determine if suspicious trading activity involves insider trading. These include identifying those who traded before a material corporate event and determining if the traders are actual insiders or can be linked to insiders.

SROs Develop Initial Evidence and Refer Cases to the SEC

Typically, the SROs will identify which brokerage firms executed trade orders before a corporate event that may involve insider trading and then obtain and review records of those firms to identify retail customers trading during the period in question. The SROs also attempt to match the list of traders against related corporate insiders and those insiders' business and personal acquaintances. The main steps used by the SROs during their investigations are as follows:

- Identify material news and determine if unusual price/volume activity occurred prior to news.
- Obtain transaction data to identify brokerage firms trading before the material news, the volume of trading, the trading period to be reviewed, and the retail customers of selected brokerage firms who traded during the period of review.
- Determine when the news was first known to insiders by obtaining a chronology of events from the issuer. If a corporate merger, acquisition, or leveraged buyout is involved, obtain the chronology of events from both the acquiring and target companies.

- Compile a list of insiders from the chronologies and various business and legal indices and compare the list of insiders against customer data obtained from the brokerage firms.
- Contact registered representatives at the brokerage firms involved to obtain selected information about certain clients who executed trades during the review period. (This may involve taking depositions from member organization employees.)
- Request the company issuing the stock that broke the parameters to provide further information on the investors identified in the analysis of transaction data.
- Analyze evidence and prepare a closing report that includes the results of the investigation and the recommended disposition, i.e., referral to SEC.

In this manner the SROs may establish that a major corporate event has occurred, unusual trading occurred before the event, and certain individuals or firms executed trades during this period. The SROs may also determine that trades were executed through new accounts, initiated by individuals who live or work in the same zip code area or who may be associated with directors or officers of the company issuing the stock in question, made by foreign institutions, or concentrated in certain brokerage offices. Nevertheless, if the individuals or firms are not obvious insiders, then additional evidence must be obtained to determine if linkages exist between the traders and someone who had access to inside information.

The participants in insider trading schemes may be individuals, such as registered representatives of brokerage firms subject to SRO jurisdiction, or they may be corporate directors, officials, attorneys, or other individuals who are outside the SROs' reach. Therefore, the SROs frequently refer the results of their insider trading investigations to SEC.

SEC Tries to Establish Linkages Between Suspicious Trades and Insiders

SRO referrals are one of several sources of information and evidence that SEC uses in its insider trading investigations. The referrals usually require additional evidence to determine whether linkages exist between the trading activity and insiders. Such linkages cannot always be determined by analysis of the testimonial evidence and trading records obtained by the SROs, particularly if insider traders have attempted to conceal their trades. SEC can use its statutory authority to subpoena individuals to produce documents and appear to testify in an attempt to make the linkages that are necessary for an enforcement action. SEC can

also attempt to invoke the provisions of international treaties or memoranda of understanding between international regulatory bodies in order to determine the identity of those trading through foreign institutions.

SEC officials have said there are usually no independent eyewitnesses to insider trading. In other words, the act of acquiring inside information and trading on that information is seldom directly observed by witnesses who are apart from the illicit trading scheme and whose testimony could later be useful for conviction. Therefore, it is necessary to circumstantially link traders or those supplying the inside information to the illicit trading activity.

Each SEC investigation is slightly different from its other investigations, making generalizations difficult. Nevertheless, we highlight below some of the investigative approaches and some of the steps SEC uses in developing its cases.

SEC enforcement staff may subpoena the telephone records of insiders and/or the traders identified by brokerage firms to determine if calls were made between these individuals. If calls are discovered, then the date and time of the calls can be compared to both the corporate chronology of events leading up to the public announcement of material news and the trade dates. In other instances, subpoenaed financial records may be used to establish or confirm linkages. A case may be aided by discovery of a flow of funds between those with inside information and others who were tipped and who actually traded.

A synopsis of the evidence obtained using these techniques in one case is provided below.[6]

Case Synopsis Illustrating SEC Investigative Techniques

This synopsis illustrates how the SEC used bank checking account records and telephone records to link those involved in the insider trading scheme between Joseph Gaffney and two friends. Joseph Gaffney, a resident of Pennsylvania, was the Vice-President of Industrial Relations of Coplay Cement who, in that capacity, became aware of merger discussions between his company, a Pennsylvania corporation, and Louisville Cement, a Kentucky corporation. Coplay is a more-than-99-percent-owned subsidiary of Eurocem, Inc., a Delaware corporation that is a

[6]The information for the case synopsis was obtained from the complaint SEC filed in federal court for SEC v. Joseph Gaffney, Guy Speciale, and James Moran, Civil Action No. 85-2967 (S.D. N.Y., filed April 18, 1985). The complaint is a public document.

wholly-owned subsidiary of Societe des Ciments Francais ("SCF"). SCF is a French corporation with executive offices in Paris, France. James Moran, a resident of New York, and Guy Speciale, a resident of New Jersey, were friends of Gaffney. A specific chronology of events is contained in table 3.1.

Table 3.1: Chronology of Events in an Insider Trading Case

Date/period	Event
08/01/84	Gaffney telephoned Moran.
08/07/84	Moran purchased 400 shares of Louisville Cement common stock selling at approximately $39 for $15,800.
08/10/84	Gaffney signed and sent Moran his personal check for $15,000 as a loan. Moran applied these funds towards the purchase of the 400 shares. Moran and Speciale continued to trade in Louisville Cement stock over the next several weeks.
09/20/84	Gaffney telephoned Moran 1 day after a negotiating session between Coplay and Louisville Cement, and they spoke for 20 minutes.
10/22/84	Moran and Speciale spoke by phone on nine separate occasions on this 1 day. Merger discussions were not going well. Both sold shares on that day.
10/23/84	AMEX detected that the volume of trading in Louisville Cement was 7 times the average volume for the preceding 25 days, and the price rose $6 per share.
10/23/84 - 10/26/84	Additional suspicious trading was detected, some emanating from foreign locations.
10/30/84	Merger agreement announced. The purchase price was $72 per share.
11/13/84 - 01/22/85	Moran and Speciale sold shares and made profits of about $57,300 and $81,500, respectively.

SEC gathered direct evidence of the defendants' trading activity and eventual profits by examining a brokerage firm's records. However, making the linkage between a corporate officer with inside information and those trading depended upon circumstantial evidence. Those circumstances included a transfer of funds from the insider to another defendant during the period of merger negotiations and telephone discussions between the defendants prior to stock trades. By themselves, bank records on the transfer of funds did not provide evidence of an illegal act. Neither did records of telephone conversations, particularly when phone records do not prove the nature of the discussions. Nevertheless, when all the facts were analyzed in conjunction with the timing of the trading activity, they provided SEC with a circumstantial basis for a civil action.

In this case, a civil action was filed in the U.S. District Court for the Southern District of New York. Without admitting or denying the allegations, the three defendants consented to the entry of Final Judgments restraining and enjoining them from violating the securities laws and

requiring them to disgorge illegal profits totalling $138,765 and to pay penalties totalling $88,755.

This synopsis is not intended to cover all aspects of case development but to illustrate that SEC obtained evidence linking individuals involved in insider trading schemes through telephone conversations and money flows.

SROs Analyze Numerous Trading Patterns but a Small Percentage Result in SEC Investigations

While the SROs identify thousands of trades that require analysis, only a small percentage of the trades is referred to SEC for investigation, and fewer result in an SEC investigation.

SRO Monitoring and Investigation Results

Although the numbers are not necessarily comparable, data obtained from the four SROs we visited provide an indication of the large number of trades that the SROs review. NYSE management reports show staff assigned to its stock watch unit reviewed 5,135 parameter breaks in 1985 and 9,665 in 1986. AMEX's Stock Watch analysts conducted 11,804 trading reviews in 1985 and 10,410 in 1986. NASD reviewed 11,842 on-line alerts in 1985 and 16,556 in 1986. CBOE staff rely on news events to initiate insider trading investigations and examine trading prior to the significant corporate news. They reviewed 8,712 of these news events in 1985 and 9,099 in 1986. In total, for fiscal years 1985 and 1986, the SROs conducted 83,223 initial inquiries of anomalous trading activity that either broke surveillance parameters or occurred prior to major corporate events.

The four SROs completed and referred to SEC a total of 468 insider trading investigations in fiscal years 1985 and 1986. Of these 468 referrals, SEC opened 208 investigations or "matters under inquiry" (MUI) but decided not to open investigations for 253 of the remaining 260 referrals. (Seven were still pending at SEC at the time of our inquiry.) An SEC Division of Enforcement official said that SEC had not opened investigations or MUIs for the 249 cases for a number of reasons, including age of the referral, insufficient evidence of any connections between insiders

and the trading activity in question, little or no profits, or some combination of these reasons. Table 3.2 shows the disposition of all 468 referrals.

Table 3.2: Disposition of SRO Referrals for Calendar Years 1985 and 1986

Disposition	Number
SEC opened investigation or MUI	**208**
SEC did not open an investigation because of	
Age of referral	5
Failure to establish connections	12
Little or no profits	48
Combination of age, failure to establish connections, and little or no profits	188
Subtotal	**253**
Pending	7
Total	**468**

The same Division of Enforcement official said SEC has no specific criteria for deciding whether to open an investigation on the basis of an SRO referral. For example, if the dollar amount involved in a referral is very low but the facts are clear and the probability of success is high, SEC would probably work the referral. In contrast, if the dollar amount were low and the case difficult to pursue, SEC would probably take no action.

SEC Investigation Results

During fiscal years 1985 and 1986, enforcement actions alleging insider trading were initiated in 45 SEC investigations. Many investigations resulted in more than one enforcement action and involved more than one defendant. Table 3.3 provides information on the number of respondents/defendants involved and the enforcement actions resulting from these investigations.

Table 3.3: Insider Trading Enforcement Actions Filed by SEC for Fiscal Years 1985 and 1986

FY	Number of investigations	Number of respondents/ defendants	Number of civil injunctions	Number of defendants enjoined	Ordered to disgorge		Ordered to pay ITSA penalties		Number of admin. proceedings	Number of respondents barred
					Number of defendants	Amount	Number of defendants	Amount		
1985	18	45	16	32	24	$2,068,796	4	$158,492	8	7
1986	27	95	32	86	58	30,169,341	24	3,731,269	6	6
Total	**45**	**140**	**48**	**118**	**82**	**$32,238,137**	**28**	**$3,889,761**	**14**	**13**

Note: A description of the administrative and civil sanctions used by SEC in insider trading and other cases is provided on pages 16 and 17.

SEC and SROs Have Taken Steps to Improve the SRO Investigation and Referral Process

Before 1987, the SEC did not keep track in any systematic way of the SROs' referrals of insider trader investigations. Also, the SROs told us that they needed more specific feedback from SEC concerning the disposition of SRO referrals to SEC's Division of Enforcement. In the absence of this feedback on the results of their referrals, it was difficult for the SROs to know when or how to adjust their investigative and referral efforts to meet SEC's prosecutorial standards.

In our discussions with SEC enforcement officials, they acknowledged that they had not routinely provided feedback on referrals in the past and said they were taking steps to facilitate the flow of information between SEC and the SROs. First, the Division of Enforcement set up a system to record the receipt of the SROs' investigative referrals and track their status. Second, the enforcement staff began holding quarterly meetings with the SROs to discuss the status of their referrals. The first of these occurred in September 1987.

The steps described above should help SEC enforcement staff and their counterparts in the SROs coordinate insider trading investigations and reduce the number of referrals that do not result in SEC investigations. Close coordination is particularly important because SEC does not have and probably cannot develop specific criteria for opening investigations. Along with these steps to improve the coordination of SRO-SEC referrals, the removal of obstacles that delay or impede SEC's and the SROs' investigations will be necessary to strengthen their ability to detect and deter insider trading.

Strengthening Regulators' Ability to Detect and Deter Insider Trading

Insider trading is, by its nature, a particularly difficult crime to detect and prove, and circumstantial evidence is typically used to demonstrate its occurrence. Because of this, gathering and presenting evidence as quickly as possible can be critical to successful investigations. SEC and the SROs face several obstacles that delay their investigations of possible insider trading. Obtaining and analyzing broker/dealer data identifying persons responsible for suspicious trades, one of the most time-consuming aspects of an investigation, can cause lengthy delays. Moreover, when the suspected insider trading involves foreign institutions, SEC encounters further delays and is sometimes unable to successfully complete investigations.

While prison sentences and other strong penalties have been recommended to deter insider trading, the difficulty of gathering direct evidence, coupled with the lack of a precise definition of insider trading, is an obstacle affecting SEC's ability to pursue criminal sanctions under the federal securities laws.

Insider Trading Is Difficult to Detect and Prove

According to SEC, insider trading is a difficult violation to detect and even more difficult to prosecute. In April 1987, for example, the Director of the Division of Enforcement stated that insider trading was the most serious enforcement challenge facing SEC. Emphasizing that the nature of the crime creates difficulties for SEC in gathering evidence, he said:

> "Unlike some types of law enforcement surveillance, such as radar to detect speeding or the monitoring of national borders to intercept contraband, surveillance of the securities markets cannot uncover direct evidence of insider trading violations. Instead, market surveillance simply reveals suspicious trades and trading patterns, which must then be fully investigated to determine whether violations have actually occurred."[1]

Even when the trading is considered suspicious, SEC often encounters difficulties in gathering evidence of all the underlying facts and circumstances. Insider traders seldom confess their conduct, and they usually can avoid creating documents or other hard evidence of violations. According to SEC, individuals involved in an insider trading conspiracy often go to great lengths to avoid creating evidence that might lead to their detection.

[1]Statement of Mr. Gary Lynch, Director of the Division of Enforcement, SEC, before the Senate Committee on Banking, Housing, and Urban Affairs, April 22, 1987.

When the suspicious trades originate from a foreign country, the detection and prosecution of insider trading is even more difficult because SEC's investigative subpoena power is generally limited to persons and entities within the United States. Even when foreign persons or firms are effectively served with subpoenas, foreign secrecy and blocking laws may prohibit the disclosure of requested information. Since obtaining direct evidence is so difficult, SEC must decide whether to proceed solely on circumstantial evidence after many of its investigations.

Identifying Persons Responsible for Unusual Trading Is a Slow Process

Both the SROs and SEC sometimes encounter lengthy delays in identifying the persons responsible for trades considered unusual or suspicious, which can reduce the quality of evidence obtained. In particular, the SROs' referrals to SEC usually take months, and sometimes years, primarily because of the time required to manually process and analyze data obtained from broker/dealers and to identify underlying customers. A project currently underway, called the "electronic blue sheet project,"[2] is expected to speed up this data processing and help identify patterns of suspicious trading activity.

SEC Needs Timely Referrals

SEC has emphasized to us and Congress the need for timely SRO investigations and referrals. In May 1987, one SEC Commissioner testified that because of the crucial role that the SROs play in detecting insider trading, ensuring prompt referrals to SEC is critical.[3] Commenting on the timeliness of the referrals and the need to detect patterns of suspicious trading, he said:

> "While examinations of SROs revealed generally sound procedures, the [SEC] staff noted two areas in which improvement was needed. First, SRO referrals to the SEC often are delayed to an extent that subsequent investigation is hampered. Second, because investigations typically focus on trading in a single issue, a suspicious trading pattern emerging from several issues often was not detected."

In this regard, SEC staff said they believe judges are less sympathetic to SEC's position in a case when the evidence is stale and the actual violative conduct occurred several years before the case was filed in court. In such instances, witnesses may state they cannot remember key events,

[2]The term "blue sheet," or blue sheeting, refers to the process used by the SROs and SEC to learn the identity of retail customers who placed trade orders through broker/dealers. It is derived from the blue color of the SEC form, Security Transaction Questionnaire, used for this purpose.

[3]Statement of Mr. Charles C. Cox, SEC Commissioner, before the House Subcommittee on Telecommunications and Finance, May 5, 1987.

which reduces the value of their depositions. If the questioning occurs close to the trading event, witnesses have a more current recollection. Uncooperative witnesses may be less tempted to repeatedly reply "I don't remember" and may provide a definitive statement instead. Also, timely completion of SRO referrals frees the staff of those organizations to work on other matters.

Several SEC inspection reports expressed concern about the age of SRO referrals. As noted earlier (see p. 37), SEC sometimes did not open investigations because of the referrals' age. Many of the referrals took longer than a year, as table 4.1 shows.

Table 4.1: Elapsed Time for SROs' Referrals to SEC for 1985 and 1986 Combined

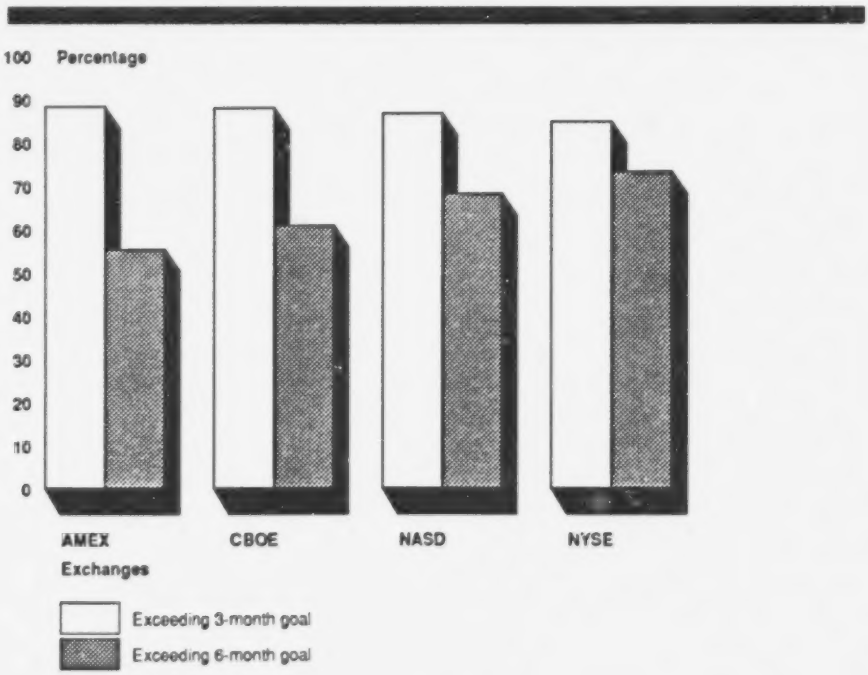
Number of days	AMEX		CBOE		NASD		NYSE		Total	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
1-90	9	11.8	13	12.2	28	13.5	12	15.4	62	13.2
91-180	25	32.9	29	27.1	38	18.4	9	11.5	101	21.6
181-270	25	32.9	35	32.7	40	19.3	10	12.8	110	23.5
271-365	15	19.8	24	22.4	59	28.5	9	11.6	107	22.9
Over 365	2	2.6	6	5.6	42	20.3	38	48.7	88	18.8
Total	**76[a]**	**100.0**	**107**	**100.0**	**207**	**100.0**	**78**	**100.0**	**468**	**100.0**

[a]This does not include AMEX's 36 options referrals, most of which were referred to SEC by phone.

From referral listings provided by SEC and the SROs, we determined that between 55 and 73 percent of the referrals took longer than 6 months. Figure 4.1 shows the percentage of referrals for each SRO exceeding 3 months as well as 6 months.

SEC and SRO staff indicated that some matters are brought to SEC's attention more quickly informally, sometimes over the telephone, and later followed by the formal written SRO case referral report. Our review of actual referrals and SRO records showed that phone referrals were made, but we were unable to evaluate the timeliness of these referrals because SEC and the SROs, with the exception of AMEX, did not keep records of the phone referrals during the period studied. AMEX did provide a listing of phone referrals that included the referral dates; however, we were unable to verify these with SEC because it did not have records of phone referrals received. In June 1988, SEC staff informed us that they now keep such records. Also, SEC enforcement officials said that although

Figure 4.1: Percentage of SRO Referrals Exceeding 3-Month and 6-Month Goals for 1985 and 1986 Combined



they have initiated investigations on the basis of phone referrals, written reports are likely to be more complete; they may provide a better basis for an informed determination about instituting an investigation.

In its comments on a draft of this report, AMEX expressed concern about how we determined the age of its referrals. AMEX calculated the age of its referrals, using the phone referral dates in lieu of the written referral dates for some cases and including its 36 options referrals as well. According to AMEX, 80 percent of its 1985 and 1986 referrals to SEC took longer than 3 months, and 46 percent took longer than 6 months. Compared to our calculations, shown in figure 4.1, this represents an 8-percent decrease in the number of referrals exceeding 3 months and a 9-percent decrease in the number exceeding 6 months.

In early 1987, SEC and each SRO agreed to an average of 3 months and a maximum of 6 months as goals for completing investigations and subsequently referring matters to SEC. SEC officials in both the Divisions of Market Regulation and Enforcement said they were dedicated to having the SROs reach the timeliness goals. They said, however, that completion

of the electronic blue sheet project will be necessary before the goals can be achieved. They also said the SROs will need to, and were expected to, increase staffing to achieve the goals.

Both AMEX and NYSE expressed concern about the length of time for insider trading investigations and provided information on steps they had taken to accelerate the timeliness of referrals. For example, both AMEX and NYSE are receiving blue sheet data electronically from some member firms. In addition, in 1987, NYSE added 17 additional persons to its staff involved in insider trading investigations. Additional details on enhancements implemented by NYSE and AMEX are included in their comments in appendixes II and III, respectively.

Automating Blue Sheet Data Is a Key to Improving Timeliness

Although other actions may be required as well, SEC officials began emphasizing as early as February 1984 the importance of automating the blue sheet process in order to reduce the time and resources required for insider trading investigations. Progress has been slow on this project for many years. But within the past 4 months, things have improved, especially among certain broker/dealers working with NYSE and AMEX.

For insider trading cases, obtaining and analyzing data to identify customer trading that is maintained by broker/dealers is essential to the development of the investigations. Both SEC and the SROs send "blue sheet" questionnaires to the various securities firms to learn the identity of the record owner of the trades in question. According to SEC and SRO officials, the analysis of the questionnaire results can be the most time-consuming aspect of an investigation. Although many broker/dealers maintain the information needed to comply with the securities regulators' requests in their automated systems, they produce the information by typing it directly on the blank forms or, more often, by sending a computer printout of the information.

SEC and SRO officials cited several problems with this system, including:

- Each brokerage firm had a different format for its retail customer data processing system, which hindered an analyst's review of the trading data.
- Many firms sent "computer dumps" of customer data rather than the selected data elements that are requested, requiring the analyst to sift through more data than necessary.

- Because of formatting differences and extensive trading activity, SEC sometimes had to re-keypunch the customer data into a computer program for the staff to use in attempting to make linkages among traders.

The goal of the electronic blue sheet is to develop a system that will standardize SEC and SRO questionnaires and the replies of the various brokerage firms. Once the automated blue sheet process is fully implemented, securities regulators will be able to ask for and receive specific customer information in a standard format on computer tape or floppy disk. According to an SEC official, successful completion of the project will allow the regulators to develop software programs that will automate and further facilitate the search for linkages among traders using inside information.

The electronic blue sheet project has been discussed by SEC, the Securities Industry Association (SIA), the SROs, and broker/dealers for several years. The efforts through March 1988 generally focused on determining what modifications to their existing systems would be necessary to provide the data electronically, including

- deciding how the data would be transmitted among the various users,
- developing a common coding scheme for use by all organizations that would be furnishing and using the data, and
- testing the transmission and use of sample data.

Also, the SROs have proposed or are considering rule changes requiring broker/dealers to submit data in a prescribed automated format. A brief history of these efforts and the project's status as of July 1988 follow.

Efforts to Automate the Blue Sheet

In February 1984, the former SEC Director of Enforcement proposed to SIA that a group be formed to determine the most feasible means of obtaining blue sheet information in a computer-readable format. He described the blue-sheeting process as labor-intensive and time-consuming and cited the benefits to the broker/dealers and SEC of automating the process. In July 1985, the current Director proposed to initiate a dialogue with SIA concerning the subject and requested SIA to submit suggestions on how to proceed with obtaining automated blue sheet data. Afterwards, meetings were held to discuss the approach and to identify concerns; in December 1986, SIA submitted a proposed record layout of an automated blue sheet to SEC staff for comments. SEC staff sent a revised record layout to SIA, NYSE, and to brokerage firms in April

1987. That same month, SIA transmitted the blue sheet layout to SIA members.

Also, in early 1987, NYSE provided a proposed format of the automated blue sheet, including computer specifications for its use, to 34 of its member firms. These firms, primarily the big retail houses, accounted for 75 percent of the blue sheet requests involved in NYSE investigations. According to NYSE, the responses received as of March 1987 had been generally favorable. In May 1987, NYSE mailed the final format of the electronic blue sheet with instructions to the 34 firms and stated that NYSE's facilities at the Securities Industries Automation Corporation (SIAC) would be able to accept trading information by automated transmissions by June 1, 1987. In December 1987, NYSE provided information on the blue sheet format to 79 additional member organizations, which were occasionally asked to provide information for investigations. It requested comments on the compatibility of the format with their current systems and the transmission methods the firms would use to electronically send the information.

In addition, in July 1987, NYSE sent a proposed rule change to SEC for its review. The rule would require all NYSE members and member organizations to submit blue sheet data in an automated format prescribed by NYSE. NYSE recognized that smaller firms may find the automated reporting requirement more burdensome than larger firms and, as proposed, the rule authorizes NYSE to grant exceptions. NYSE also added to its list of rule violations subject to summary fines the "failure to comply with NYSE reporting requirements in a timely manner." This rule change, which was approved by the Commission in June 1988, provides that the 34 larger firms contacted in early 1987 be given 30 days, from the date of SEC approval of the proposed rule change, to comply with the requirements of the rule. Further, the 79 firms contacted in December 1987 will be given 6 months from the date of approval of the proposed rule to either comply with the requirements or receive an exemption from the rule.

In April 1987, SEC notified SIAC that a common format for collecting blue sheet data had been developed to fit both SEC and NYSE needs. SEC proposed that SIAC serve as a collection point for the data and subsequently add these data to the tapes of other data being provided already by SIAC to SEC. SEC requested SIAC to provide cost and scheduling estimates and identify any problems involved.

SIAC responded in October 1987 with its proposal, stating that the software had already been developed for NYSE and that NYSE would permit its use for SEC purposes free of charge. SIAC provided its cost estimate and advised that it would begin collecting data 10 days after SEC approval of the proposal.

Project's Current Status

SEC officials in the Divisions of Enforcement and Market Regulation did not have an anticipated completion date as of March 1988. SEC and SRO officials advised us that NYSE is now taking the lead on this project and to contact NYSE for the current status.

In March 1988, we contacted NYSE, along with NASD, AMEX, and CBOE, for this information. Of the 34 firms initially surveyed, which accounted for 75 percent of the blue sheet requests involved in NYSE investigations, we found that NYSE was receiving, through SIAC, blue sheet data in electronic form from 9 firms on a regular basis. NYSE had received tapes containing test data from 11 others who were expected to be submitting data regularly by mid-1988. The remaining 14 firms had not completed the necessary modifications to their systems to electronically transmit the data in the prescribed format. NYSE had no estimates as to when the other 79 firms surveyed in December 1987 would be electronically submitting blue sheet data.

In July 1988, NYSE, which is taking the lead in this project, provided us with updated information on the electronic blue sheet project. Fifteen of the 34 firms initially contacted by NYSE in early 1987 were submitting data electronically to NYSE as of July 1988. These 15 firms provide clearing services for, and were submitting electronic blue sheet data for, an additional 62 firms, 7 of which were among the 79 notified in December 1987. Also, 1 of the 79 firms that NYSE contacted in December 1987 was submitting its own data electronically. Therefore, 23 of the 113 firms contacted by NYSE in 1987 were reporting blue sheet data electronically as of July 1988.

AMEX, which also receives blue sheet data through SIAC, is working with NYSE on this project and can receive data in electronic form from the same firms that are reporting to NYSE. AMEX also sent a proposed rule change to SEC that would require member firms to submit requested information in the new automated format. This proposal was submitted in January 1988 and approved by the Commission in June 1988. Under the new NYSE and AMEX rules, all member firms, other than those exempted, will be required to submit customer and proprietary account

trade information electronically. AMEX, in the interest of uniformity, will employ the same compliance deadlines as NYSE (30 days for the firms initially contacted in early 1987 and 6 months for the firms contacted in December 1987). However, in July 1988, a NYSE official told us that the new rule change had not yet been distributed to member firms and, therefore, the compliance deadlines had not yet been imposed.

As of March 1988, NASD was not receiving blue sheet data electronically in the prescribed format from any firms. In its March 1988 report, NASD's Regulatory Review Task Force recommended that NASD also implement an automated blue sheet system. Specifically:

"... the Task Force found that the use of written questionnaires to obtain customer account information (either in hard-copy or manual form) tended to delay the progression of cases and often created substantial processing burdens for the NASD and the membership."

The Task Force supported expansion of the pilot program under which members submit customer information in a computer-compatible form and proposed rulemaking to require that member firms have a minimal capacity for electronically transmitting regulatory information to NASD. However, an NASD official said they still had questions about the prescribed format for the data collection and transmission.

As of March 1988, CBOE was not receiving blue sheet data electronically in the prescribed format from any firms. CBOE was installing a system to receive electronic data from SIAC, which is to act as information processor for CBOE. Once the system is installed, CBOE will be able to receive blue sheet data electronically from the same firms that are reporting in this fashion to NYSE and AMEX.

Regarding SIAC's October 1987 proposal to SEC, officials in SEC's Divisions of Enforcement and Market Regulation said there had been problems with the contract negotiations. However, in June 1988, SEC informed us that all contracting issues between SEC and SIAC had been resolved, and SEC had been granted access to electronic "blue sheet" information to test transmission procedures and the accuracy of information received.

Automated Blue Sheets May Help to Detect Suspicious Trading Patterns

Insider trading investigations involve analyzing trading occurring before a single corporate announcement. Receiving the blue sheet or trading data in electronic or automated form will better facilitate this analysis and enable SEC and SRO staff to identify patterns of suspicious trading.

As shown earlier (p. 37), SEC rejected 253, or about 53 percent, of the 468 SRO referrals in fiscal years 1985 and 1986. In these 253 referrals, the SROs' analyses and investigations did not result in a timely referral to SEC, did not identify illegal profits large enough to warrant an SEC MUI or investigation, or did not uncover any clear linkages between those trading and those in position to have inside information. SEC did not open an investigation for one or more of these reasons. Nevertheless, it may have been possible that the person(s) named in the referrals concealed their connection to insiders and their access to inside information. In addition, each trade alone may not have been significant enough to investigate. However, if the same persons were repeatedly named in the referrals, the cumulative illegal profits may have been large enough to warrant an SEC investigation and to help persuade foreign governments to release the names of the beneficial owners involved.

One SEC enforcement official noted in this regard that the case against Mr. Dennis Levine illustrated this weakness in former investigative techniques. At the time of Mr. Levine's arrest in May 1986, SEC and the SROs did not have an effective procedure for identifying whether the same person or organization was being repeatedly identified in investigations. Mr. Levine had executed trades in stock of 54 companies through a single foreign institution over a 5-year period. However, it was not determined until after Mr. Levine's arrest that numerous investigations previously referred to SEC by NYSE included trades that had been executed by Mr. Levine.

Automating the blue sheet data should help identify and match the names of persons identified in SRO investigations and referrals and thus help establish patterns of suspicious trading. Such patterns might involve the same persons or firms repeatedly trading before corporate announcements in one or more markets. This information could bolster SEC cases that are based upon circumstantial evidence if it can be demonstrated that the defendant executed trades just before corporate announcements over an extended period of time.

SEC officials said some SROs are now retaining information in order to track patterns of suspicious trades within their own markets. For example, NYSE developed an automated data base of names of individuals and

institutions who have repeatedly appeared as trading prior to corporate announcements. Also, the Intermarket Surveillance Group (ISG), which is comprised of the major equity and options exchanges and NASD, is working to coordinate intermarket surveillance and insider trading investigations by establishing a similar data bank containing certain trading information gathered by all SROs in individual investigations. The system would enable the SROs to identify patterns of suspicious trading involving both options and equities markets involving both foreign and domestic accounts. SEC informed us that an ISG subgroup will be meeting in July 1988, and initial testing of this system should begin shortly thereafter.

Other Countries' Secrecy Laws Conceal the Identity of Persons Trading

When a trade order originates within the United States, the SROs and SEC routinely use the blue sheet process discussed above to identify the person(s) identified in a broker's records as being responsible for the trades. When the order is placed through a U.S. broker by a foreign institution, however, the regulators can only identify, through the blue sheet process, the institution placing the order. As a result, those who may engage in insider trading could conceal their identities by executing trades through financial institutions in foreign countries. Other countries' blocking and secrecy laws may delay or actually prevent SEC staff from learning the identity of the record owner of the trades in question.

The existence of trading prior to major corporate events through foreign institutions is evident in SRO surveillance referrals. The SEC Division of Enforcement provided data showing that in fiscal years 1986 and 1987, it received a total of approximately 600 referrals involving suspected insider trading from all SROs. Of these, approximately 220 referrals included one or more suspicious trades executed through foreign institutions.

In some cases, the referrals identified trading through a large number of foreign institutions just before a corporate announcement. For example, in one referral to SEC, an SRO examined trading activity during a 6-trading-day period prior to the public announcement of a tender offer. The SRO identified 265,900 shares of the target company's stock that were purchased through approximately 30 foreign institutions in at least 10 countries.

Although such information obviously does not prove that insider trading occurred, it represents suspicious trading activity that SEC may find difficult to investigate. SEC can request voluntary cooperation of the foreign institution involved. However, in some countries, blocking and secrecy laws provide penalties for the improper release of records, which can preclude the institution's cooperation. SEC's authority to issue administrative subpoenas, contained in Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78 u(b)), is limited to serving them "anyplace in the United States." SEC can use the right of discovery in civil litigation, but again, it has found that foreign blocking and secrecy laws present particularly difficult obstacles in some cases.[4]

Blocking laws generally reflect the legislative decision of a country to protect certain types of information most often related to international commerce or trade, national security, and economic matters. The laws often prohibit even voluntary disclosure of information to foreign governments for use in legal proceedings and provide civil and criminal penalties for violations. Secrecy laws establish rights by which individuals may require others to keep secret specific information. They may take different forms, ranging from statutes that prevent disclosure by any fiduciary to specific bank secrecy laws. Secrecy laws may contain civil and criminal penalties as well.[5]

These laws can prevent, or at least delay, SEC when it tries to identify the persons responsible for trades in which it and the SROs suspect the use of inside information.

Earlier SEC Approach Met With Opposition

SEC has recognized that because of blocking and secrecy laws, it faces serious difficulties in policing transactions executed in the United States from foreign countries. It has explored approaches to overcoming the difficulties, including an approach referred to as "waiver by conduct." Under this concept, the purchase or sale of securities in the United States, whether directly or indirectly, would constitute a waiver of the applicability of the foreign secrecy laws. Such purchase or sale would

[4]Additional detail on SEC's methods of obtaining information, including agreements for production of evidence, is contained in Internationalization of the Securities Markets, Report of the Staff of the U. S. Securities and Exchange Commission to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Energy and Commerce, July 27, 1987.

[5]Countries with blocking laws include France, the United Kingdom, Canada (Ontario), and Switzerland. Countries with secrecy laws include the United States, Switzerland, the Cayman Islands, the Bahamas, Liechtenstein, and Panama.

serve as an implied consent to disclosure of information and evidence relevant to any SEC investigation.

In July 1984, SEC invited public comments on the waiver by conduct approach as a way of improving its ability to investigate and prosecute persons who trade in the U.S. markets. SEC sought comments with analytical evaluations of the factual, legal, and policy questions involved. SEC believed that the comments not only would lead to an evaluation of the waiver by conduct approach but also would identify other approaches Congress might adopt and SEC might use to police the problem.

SEC received voluminous comments from commentators in the public and private sectors, both in the United States and other countries. The Chief of SEC's Office of International Legal Assistance, Division of Enforcement, characterized most of the comments as negative. He cited three general points used to support arguments against adopting the concept.

- It represented an extraterritorial extension of American law to nationals who conduct transactions through foreign banks and brokers.
- It would be unenforceable under most foreign laws and therefore would not resolve the existing conflict.
- It would drive business away from the U.S. markets.

According to this SEC official, the only comprehensive alternative proposed was the negotiation of bilateral and multilateral arrangements. Because of this, SEC did not pursue the waiver by conduct concept. As recommended by many foreign commentators, it has since followed the approach of negotiating agreements with other countries in order to obtain the information and evidence it needs to enforce U.S. securities laws.

U.S. Agreements Provide a Basis for Obtaining Access to Evidence

SEC has available several types of agreements to obtain foreign institutions' records. These include private agreements between the United States and foreign exchanges; memoranda of understanding (MOU) between the United States or SEC and specific foreign governments or securities authorities; and treaties between the U.S. government, represented by the Department of State, and foreign governments for mutual assistance in criminal matters. While SEC and other federal agencies have been successful in negotiating agreements with some countries, access agreements are not in effect for some countries with a large and growing volume of trading in the U.S. markets.

Table 4.2 presents data, published by SIA, on trading by foreign countries in the U.S. markets and shows the type of agreement, if any, in effect.

Table 4.2: Gross Transactions in U.S. Equities by Foreign Countries and Type of Access Agreement in Effect

In billions of dollars

Country[a]	Period 1985	Period 1st Qtr. 1987	Type of access agreement in effect as of March 1988
United Kingdom	$37.7	$25.4	MOU
Switzerland	21.5	15.3	Treaty and MOU
Canada	22.1	12.9	MOUs and private agreements
Japan	7.5	17.7	MOU
Bermuda	9.1	2.9	None
Netherlands Antilles	7.6	4.5	None
Germany	6.1	3.8	None
France	6.0	4.5	None
Belgium-Luxembourg	4.4	2.6	None
Netherlands	4.0	2.0	Treaty
Hong Kong	3.5	2.8	None
Other	28.2	18.6	
Total	**$157.7**	**$113.0**	

[a]In addition to access agreements relating to the specific countries for which SIA-published trading data were available, treaties regarding mutual assistance in criminal matters were in force with Turkey and Italy. Also, as of May 1988, treaties had been negotiated but were not yet in force with Colombia, Morocco, Canada, and the Cayman Islands.

As shown above, trading in the U.S. markets by these countries totaled $113.0 billion in the first 3 months of 1987. This is 72 percent of the $157.7 billion in trading by the same countries for all of calendar year 1985. Also, agreements were in effect for 5 of the 11 countries indicated.

Essentially, the agreements provide SEC with a basis for requesting the evidence it needs. However, SEC must show that certain conditions are met before some foreign authorities will consider releasing evidence. For example, the Swiss MOU imposes high trading thresholds and other conditions that must be met before evidence is released.

To identify persons trading through a Swiss institution, SEC must transmit a request for assistance to a three-member commission of inquiry appointed by the Swiss Bankers' Association. The Swiss commission will examine the request and determine if the basic thresholds (such as at least a 50-percent increase in the daily trading volume or price of a

security during a defined period) are met or, if they are not, whether sufficiently suspect circumstances are presented in the SEC request.

If the conditions are met, the Swiss commission will order that the bank freeze the customers' accounts up to the amount of profit realized in the trades in question and may call for a report from the bank on the transactions concerned. After the freeze, the banks will inform their customers of the request, give the customers an opportunity to respond to the allegations in the SEC request, and report all information back to the commission within 45 days. Unless the Swiss commission determines that the customer did not make the trades or was not an insider, the commission then forwards the report to the Swiss Federal Office for Police Matters for transmission to SEC.

Agreements with other countries similarly provide SEC with access to evidence in specifically identified areas. If suspicious trading emanates from countries the United States has no agreement with, SEC must negotiate for the production of evidence (i.e., the identity of the beneficial owner of the trade) through the State Department.

Although agreements provide a means for SEC to obtain evidence from foreign countries, it is not an expeditious process. SEC officials said they exercise care in selecting cases that fall within an agreement in order to avoid the appearance of conducting "fishing expeditions." SEC management determines if the trading volume, profits, and other case circumstances warrant the effort and expense needed to gather evidence in this manner.

Actions That Might Strengthen the SEC's Negotiating Position

We identified actions that might enable SEC to strengthen its position when negotiating for the release of information it needs for its investigations. Although we did not explore all the ramifications of these actions, SEC enforcement staff believed they have merit.

Developing Trend Data for Use in Negotiations

SEC and the SROs have recognized the need to analyze trends identified in investigations of trading occurring before corporate events. As discussed above, once the blue sheet automation project is completed, SEC will be in a better position to gather information on and analyze patterns of suspicious trading executed through both domestic and foreign accounts. The results of such analyses could be useful in negotiating new agreements and access under existing agreements. Also, the

Intermarket Surveillance Group's planned system could be used to identify suspicious trading within and among various U.S. markets.

SEC enforcement officials agreed that such data could be useful in negotiations with foreign governments and foreign institutions for release of the names of persons trading in U.S. markets. For example, if a foreign financial institution is repeatedly identified as trading before corporate events, SEC could use this information to help convince foreign governments and institutions to release information identifying the beneficial owners of the securities involved.

Determining the Size of Underlying Customers' Trades

The SROs' investigations do not reveal the size of individual customer trade orders placed through foreign institutions. U.S. brokerage firms do not routinely obtain such information; they process orders from foreign financial institutions in bulk, using "omnibus accounts." As a result, the SROs and SEC cannot routinely determine the size of underlying customers' orders that are placed by foreign institutions. This information could be useful to SEC in determining which trading activity to pursue. A large order placed by a single customer before a major corporate event could indicate a need for an SEC investigation to determine who traded.

A new U.S. requirement for the routine disclosure of the size of each individual foreign order could be adopted without the need to routinely reveal the names of the persons who traded. An SEC expert on foreign legal issues told us that if this became a general regulatory requirement or condition for trading in U.S. markets, he did not believe it would violate other countries' laws. However, a request for this information, as part of an investigation, could constitute a violation under existing agreements. We did not explore with the SROs and brokerage firms the cost of requiring such routine disclosure.

The ability to identify larger trades could help SEC convince foreign countries that it is not on a "fishing expedition" when it requests information. This could, in turn, improve SEC's chances of receiving cooperation from foreign countries and obtaining evidence vital to its investigations.

Negotiating Additional Agreements With Other Governments

Although SEC has been successful in negotiating access agreements with several countries, it has recently found that the Freedom of Information Act (FOIA) is an obstacle to successful negotiations with some countries. Foreign regulators have told SEC officials that they consider certain evidence contained in their files to be confidential and would not release it to the public in their respective countries. These foreign regulators point out that SEC cannot guarantee such confidentiality because FOIA would require SEC to release the files once it closes an investigation. This potential release of foreign regulators' confidential information has impeded negotiations to establish new agreements.

In June 1988, the Commission submitted a legislative proposal to Congress recommending an amendment to the Securities Exchange Act of 1934 that would establish an exemption from disclosure under FOIA. This amendment would authorize SEC to withhold from disclosure material provided by a foreign country when it states that the public disclosure of such material would be contrary to the laws of that country.

Obstacles Associated With the Use of Criminal Sanctions for Insider Trading

The Insider Trading Sanctions Act of 1984 increased the civil penalties for insider trading, and recent legislative proposals have called for even stronger sanctions for this violation. SEC and Justice officials have stated that imprisonment is an appropriate penalty for insider trading. The Senate Committee on Banking, Housing, and Urban Affairs concluded in its December 17, 1987, report[1] that increased penalties for insider trading would increase deterrence. To discourage insider trading, the Committee proposed, in the Tender Offer Disclosure and Fairness Act of 1987, to increase criminal penalties from a maximum of 5 years to 10 years in jail and from a maximum of $100,000 to $1 million in fines. The Committee also proposed an automatic 1-year jail sentence for obstruction of justice or perjury in connection with an insider trading investigation.

Currently, SEC and Justice face obstacles in pursuing criminal sanctions for insider trading. Gathering the evidence necessary to identify and prove the existence of insider trading is difficult. Also, imposing criminal sanctions for this violation under current securities laws may be difficult, because some defendants have stated in the courts that these

[1]Report of the Committee on Banking, Housing, and Urban Affairs, United States Senate, Tender Offer Disclosure and Fairness Act of 1987 (to accompany S.1323); Dec. 17, 1987; pp. 39-40 (S. Rep. No. 100-265).

laws do not clearly define the illegal behavior that constitutes insider trading.

Gathering Direct Evidence of Insider Trading Can Be Difficult

As stated earlier, SEC and Justice often must use circumstantial evidence to prove insider trading. Currently, the investigative procedures used often do not produce the evidence necessary to clearly demonstrate whether or not insider trading occurred.

U.S. Attorneys decide, on a case-by-case basis, whether to pursue criminal sanctions for insider trading. According to SEC and Justice officials, an "access to records" approach is generally used in referring insider trading matters from SEC to the U.S. Attorney. Under this approach, those matters that SEC believes may deserve criminal treatment are brought to a U.S. Attorney's attention. If interested in pursuing the case, the U.S. Attorney will request access to the pertinent SEC case files.[7]

SEC officials pointed out that because evidence in insider trading cases is often circumstantial, it may not always meet the "beyond a reasonable doubt" threshold needed for criminal convictions. Civil sanctions are often pursued because they involve the lower "preponderance of evidence" threshold. SEC develops a civil case even when the U.S. Attorney decides to work the matter as a criminal case. Thus, if the criminal case breaks down or assets need to be frozen before they are hidden or taken out of the country, civil remedies are readily available.

Other Investigative Techniques May Be Required to Develop Direct Evidence of Insider Trading

Certain investigative techniques may be more efficient than those now available to SEC and may be necessary if criminal sanctions are to be imposed to a greater extent for insider trading. Specifically, the use of informants appears to be a useful way of obtaining direct evidence of insider trading.

SEC and Justice often use tips from the public and cooperating witnesses to provide the evidence necessary to prove insider trading. Thus, persuading individuals who are aware of insider trading or involved in it to provide information to SEC can be important to successful investigations.

[7]SEC records show that 5 criminal indictments were brought against inside traders in fiscal year 1985, resulting in 4 convictions; 16 indictments were brought in fiscal year 1986, resulting in 15 convictions. According to SEC, the indictments not resulting in convictions in both years involved defendants who were fugitives from the law.

In this regard, SEC's case experience shows that informants were instrumental in providing information in many insider trading cases completed in fiscal years 1985 and 1986. (See table 4.3.)

Table 4.3: Sources or Leads for SEC Insider Trading Cases for FY 1985 and FY 1986

Fiscal year	Number of cases	SRO	News media	Informant	SEC or other gov. agency
1985	18[a]	12	1	5	4
1986	27[b]	12	3	10	8
Total	**45**	**24**	**4**	**15**	**12**

[a]Two sources were given for four of the 1985 cases

[b]Two sources were given for six of the 1986 cases

One of SEC's most celebrated insider trading cases, which involved Mr. Dennis Levine and others, was initially brought to light partly as a result of an anonymous tip and resulted in a criminal conviction. Although NYSE had identified numerous suspicious trades made through a foreign institution, it was not until an informant had raised questions about the trading that SEC opened the investigation, obtained records from the institution, and was able to identify and arrange for the arrest of the persons responsible for the trading. SEC officials said the tip was instrumental in this investigation. This case led to further investigations and additional arrests, including that of Mr. Ivan Boesky.

Recognizing the role of informants, SEC has considered offering rewards to those who provide information that leads to successful prosecutions and disgorgements. In a roundtable discussion on the subject held February 19, 1986, the SEC Commissioners, the SEC Director of Enforcement, and certain other participants said they believed the idea might have merit.[a] The former SEC Chairman and the four current Commissioners expressed generally favorable views toward exploring the use of this technique for gathering direct evidence. They pointed out:

- "It would be more efficient to make a case using a credible witness providing direct evidence of insider trading."
- ". . . some of the SEC's most important insider trading cases have been developed as a result of information provided by informants."
- ". . . a reward program could enhance market efficiency if structured to target deceptive internal corporate activities that are otherwise difficult to discover . . ."

[a]SEC Roundtable, Market Rumors and Trading Halts, U.S. Securities and Exchange Commission, February 19, 1986.

- "... there is merit to the idea of a reward program. If a program is established to obtain information about clearly unlawful acts, it should not be limited to the insider trading area."

Also, the NYSE Chairman and the NASD President indicated that the potential application of a reward program should be explored. For example, the NYSE Chairman suggested that SEC obtain information on such programs in use at the Internal Revenue Service and elsewhere to determine possible harmful effects as well as potential benefits. The SEC Chairman pointed out that GAO had analyzed the IRS program and issued a positive report.[1]

Others from the securities industry and academia expressed views both favoring and opposing the idea. In general, the negative comments related to concern about the number of informants who might provide hearsay evidence or information of questionable value.

An SEC official said the claims for reward idea was not pursued by SEC because it would have required new legislation and because of competing priorities for SEC staff time. In May 1987, H.R. 2494 was introduced to authorize SEC to pay for information leading to the detection and prosecution of insider trading. The bill was awaiting consideration by the House Committee on Energy and Commerce as of July 1988.

Imposing Criminal Sanctions Under Securities Laws May Become More Difficult

A question exists as to whether Congress may be required to specifically define by statute the behavior constituting "insider trading" if criminal sanctions for this violation are to be imposed under securities laws. The government's use of criminal sanctions for insider trading under existing federal securities laws has been questioned in the courts. At issue, in part, is whether relevant provisions of the Securities Exchange Act of 1934 can meet the constitutional principle of "specificity" required of criminal law. Depending on future court decisions, a more precise definition of the term may be required, if contested criminal sanctions for this violation are to be sustained under the securities laws.

[1]We stated in our report to the Commissioner of Internal Revenue that the Claims for Rewards Program had helped IRS identify and collect taxes that might not have been realized without information provided by program participants. Between 1975 and 1984, the program led to the collection of about $16.4 million in taxes annually, with rewards averaging about $456,000 per year. (Administrative Changes Could Strengthen IRS' Claim For Rewards Program, GAO/GGD-85-11, Apr. 19, 1985.)

Securities Law Provisions Currently Used to Prosecute Insider Trading

Neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 define the term insider trading, and SEC has pursued insider trading by constructing various legal theories on the basis of the general anti-fraud provisions contained in these acts. As developed through case law, insider trading generally refers to trading in an issuer's securities while in possession of, or the selective communication of ("tipping"), material[10] nonpublic information about the issuer, its securities, or the market for its securities in circumstances involving misappropriation or the breach of a duty of confidentiality. The main anti-fraud provisions are Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Insider traders may include not only corporate directors and officers with a fiduciary responsibility to their companies, but others who may have gained access to material nonpublic information.[11] Thus, insider trading may involve (1) persons who receive information directly from corporate insiders for the express purpose of improperly trading the securities of the corporation ("tippees"),[12] (2) persons who receive information from insiders in confidence solely for corporate purposes ("temporary insiders"),[13] (3) persons who do not trade but who may otherwise personally gain from use of nonpublic information,[14] and (4) trading or tipping involving "market" information rather than corporate information.[15]

The misappropriation theory has recently been used in convicting insider traders who are not traditional insiders, such as a corporate official with direct knowledge of market-sensitive information. The theory holds that it is theft, or misappropriation, of confidential information by an individual, such as an investment banker or lawyer entrusted with the information about material corporate events, to use that information for personal benefit. The theory has been applied to individuals who may have stolen material information from their employers and profited

[10]"Information is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[11]SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (2d cir. 1968), cert. denied, 394 U.S. 976 (1969).

[12]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F. 2d 228 (2d cir. 1974).

[13]United States v. Newman, 664 F. 2d 12 (2d cir. 1981), cert. denied, 104 S. Ct. 193 (1983). SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal., 1983).

[14]SEC v. Gasper, et al., [1984-85 Decisions] Fed. Sec. L. Rep. (CCH) 92,004 (S.D.N.Y., 1985).

[15]David Carpenter, et al., v. United States, 108 S. Ct. 316 (1987).

or caused accomplices to profit from trades made on the basis of this information.

In a case decided by the Supreme Court in November 1987,[16] a reporter for a financial newspaper and a stock broker had been convicted of participating in an insider trading scheme based upon information misappropriated from the newspaper. The defendants argued that the misappropriation theory of insider trading liability did not fall within Section 10(b), and the theory did not provide sufficient notice to pass Constitutional muster in criminal cases. The Supreme Court's decision did not resolve these issues as to the securities laws. Although the ruling did make it clear that federal mail and wire fraud laws can be used against anyone who misappropriates confidential information and uses it for personal profit, the Court was deadlocked 4-4 on the question of whether the defendants violated U.S. securities laws. This tie vote left the defendants' convictions intact in the Second U.S. Circuit of Appeals. However, no precedent was set to apply in jurisdictions outside the second circuit.

The Insider Trading Sanctions Act of 1984 provided stronger statutory sanctions to be used against insider traders. Prior to 1984, the civil monetary sanction against insider traders was remedial and required disgorgement by the insider of any illegal profits realized. The courts also recognized the rights of private plaintiffs to sue for recovery of damages under the securities laws. Therefore, the enforcement emphasis was to return the insider to the "status quo" prior to the misconduct and to compensate victims of that misconduct.

The punitive thrust of the 1984 act is contained in its treble damages sanction. Under the act SEC may seek a civil remedy of up to 3 times the profits realized or loss avoided from the insider's trading. The act also increased from $10,000 to $100,000 the maximum criminal fine for any violation of the Securities Exchange Act. The monetary fine has since been increased to $250,000 by the Criminal Fine Improvements Act of 1987.

[16]Ibid.

Specificity of Proscribed Behavior May Be Required for Criminal Sanctions

In hearings leading to the passage of the Insider Trading Sanctions Act of 1984, consideration was given to specifically defining insider trading in federal statutes. Congress took no action on defining the term in statute but favored to continue giving SEC the widest possible flexibility in dealing with potential new versions of insider trading schemes.

In 1987, Congress again considered developing a more specific definition of insider trading. On June 17, 1987, S.1380 was introduced to define the term. On August 3, 1987, SEC submitted a separate version of the bill that incorporated concepts contained in the earlier bill but also reflected SEC's experience in prosecuting insider trading cases under current law. To resolve differences between S.1380 and SEC's version, SEC submitted a compromise proposal in November 1987. Hearings were held in December 1987 and, in support of the compromise proposal to define insider trading, SEC submitted draft legislative language to Congress in February 1988. Under this proposal, a person would be prohibited from purchasing or selling a security while in possession of material nonpublic information relating to the security, if that person knows or recklessly disregards that the information has been "wrongfully obtained," or that the purchase or sale would constitute a "wrongful use" of the information. As of July 1988, this bill was still in committee.

Conclusions

Several obstacles exist that can prevent or delay the successful investigation of suspected insider trading. They include

- the untimely gathering and analysis of broker/dealer data,
- the inability to routinely obtain trading information from foreign institutions, and
- the difficulty of producing direct evidence to prove insider trading.

A first step to successful insider trading investigations is the timely gathering of information held by broker/dealers in order to identify persons trading and any association they may have with corporate insiders. Delays in completing insider trading investigations can reduce the quality of the evidence presented to prove the government's case.

The lengthy delays in referring investigative results from the SROs to SEC can jeopardize the government's ability to identify linkages among those who may be a part of a trading scheme. Although we do not know when a referral becomes too old to work, it seems unarguable that "sooner is better," especially when the evidence used to prove insider trading is typically circumstantial.

As recognized, the regulators need a more efficient means of identifying persons responsible for suspicious trades and determining if they are "insiders" or communicated inside information to others who executed the trades. Automating the blue sheet process is a necessary step toward eliminating a time-consuming process now in use. The automated blue sheet should allow the regulators to be more efficient and thus keep pace with a growing market and corresponding growth in events conducive to insider trading. It should, in turn, assist in reducing the number of referrals by the SROs to SEC that are not worked because of "age" and "failure to make connections."

Progress is being made to implement a system that will speed up the gathering and analysis of blue sheet data, but we believe SEC should take a more active role to ensure that unwarranted delays do not occur.

Secondly, to successfully investigate suspected insider trading, it is necessary to identify the names of persons responsible for trades executed through foreign institutions. The current approach involves negotiating with other governments for the release of information necessary to investigate suspicious trading.

We have outlined several actions SEC might take to strengthen its negotiating position. We did not fully explore all the legal, policy, and cost considerations associated with these actions. Some of them, such as the requirement that foreign institutions routinely provide the size of their customers' orders, will require consideration by the SROs, brokerage firms, and possibly foreign financial institutions. Others, such as obtaining exemption from the Freedom of Information Act for foreign financial institution's records used in SEC investigations, would require congressional action.

Finally, in some insider trading cases, SEC and Justice develop evidence indicating that the appropriate sanction for a particularly egregious act is a jail sentence. Such criminal sanctions have been proposed as a more common measure for deterring persons inclined to use inside information. Given the massive vulnerability of the markets to insider trading discussed in chapter 2, policies designed to deter the crime may be the best way of protecting market integrity. Developing evidence to impose even civil sanctions is difficult. In many instances, the use of other investigative techniques, such as rewards for information leading to detection and prosecution, may be necessary.

Also, recent statements and actions by Congress and executive branch officials indicate that more frequent criminal sanctions for insider trading is a desired public policy. It is unclear, however, how the courts will rule in future insider trading cases. SEC and Justice may believe the evidence and circumstances dictate that criminal sanctions should be imposed under the securities laws. On the other hand, defendants may claim that the laws are not sufficiently clear to justify criminal sanctions. Because of this, it may become necessary for Congress to amend the securities laws to show more clearly what behavior constitutes insider trading. Congress currently has this matter under consideration.

Recommendations to the Chairman of the Securities and Exchange Commission

Because of the importance of timely information to the successful detection of insider trading, we recommend that the Chairman, in conjunction with the SROs, establish a timetable for completion of the electronic blue sheet project. This timetable should be used by SEC to monitor progress to assure that unwarranted delays do not occur.

We also recommend that the Chairman strengthen negotiations with other countries for the release of information on suspicious trades executed through foreign financial institutions. The Chairman's actions should include the following:

- Establish a policy that when blue sheet data showing trends and patterns of suspicious trades executed through foreign institutions becomes available, the data will be used in an attempt to persuade foreign governments to release the names of the beneficial owners involved.
- Determine the feasibility of foreign financial institutions routinely disclosing the size of every trade emanating from each account.

Matters for Congressional Consideration

One of the major difficulties in the investigation of insider trading is identifying if such actions are taking place. Evidence from previous cases has shown that key investigative leads often come from informants. Accordingly, as a policy matter, the extent to which Congress is willing to encourage the identification of insider trading through such a technique is a matter that it should decide. H.R. 2494 would authorize SEC to pay for information leading to the detection and prosecution of insider trading. The Subcommittee should pursue with SEC, the Department of Justice, and other appropriate law enforcement agencies the feasibility of using this technique to identify and prosecute insider traders.

In a similar vein, foreign regulators have told SEC that certain provisions of the Freedom of Information Act inhibit their willingness to cooperate with SEC. The Subcommittee may want to explore this issue further with SEC to determine the extent of the problem and whether or not legislation is needed to exempt information obtained by SEC from foreign governments from the act.

Agency and Other Organization Comments and Our Evaluation

We requested and received written comments on our draft report from SEC, NYSE, AMEX, NASD, and CBOE. Their comments are included in this report in appendixes I through V.

SEC staff said they had no major problem with the report's contents. They provided information to improve the accuracy of the report and to show the current status of certain projects discussed in the report. This information has been incorporated into the final report.

NYSE directed its comments primarily at our discussion of the timeliness of referrals to SEC and summarized several important steps it had taken to accelerate timeliness. These steps are summarized below.

- In 1987, NYSE added 17 persons to its staff involved in insider trading investigations.
- NYSE continues working with member organizations to further implement the electronic blue sheet project.
- NYSE developed, and SEC recently approved, a "Regulatory Initiatives" rules' package, which includes rules requiring members and member organizations (1) to develop procedures for reviewing all employee and proprietary trading to identify trades that may violate the prohibitions on insider trading and manipulation and for reporting the results of these reviews to NYSE, (2) to submit requested data electronically, and (3) to submit data requested by NYSE by the date required by the exchange or be subject to a fine.

According to NYSE, the average age of its referrals to SEC has dropped from 11 months in 1987 to 6 months in the first quarter of 1988. More specific information on the steps NYSE has taken to reduce how long its investigations take are included in its comments in appendix II.

AMEX generally agreed with our recommendations for improving surveillance to detect insider trading. It concurred that rapid referrals are critical to SEC's insider trading investigations. As our report shows, completing the electronic blue sheet project is key to reducing existing

delays. In this regard, AMEX agreed that SEC should develop a timetable for completing the electronic blue sheet project in order to speed up insider trading investigations and referrals.

However, AMEX expressed concern about our methodology for measuring the timeliness of insider trading investigation referrals to SEC. AMEX said that in line with SEC's requests over the years, AMEX had promptly notified by telephone the SEC Division of Enforcement of suspected insider trading when certain conditions existed. AMEX said that it maintained records of these telephonic referrals and that we should have used these records, as well as the written reports, to measure the timeliness of AMEX's referrals.

In our evaluation, we used the SROs' written referrals because SEC said telephone referrals generally do not provide enough information for SEC to determine whether to proceed with an investigation. Also, SEC did not at the time of our review maintain records of phone referrals, so it was not possible for us to verify the accuracy of the phone referral data. The SEC Division of Enforcement has since begun to keep records of phone referrals. Our report recognizes that the SROs sometimes bring matters to SEC's attention by phone and that SEC has, in some instances, opened investigations on the basis of phone referrals.

AMEX provided information showing the more recent status of AMEX projects to enhance trading surveillance and said that it had improved the timeliness of its referrals since the time of our review. AMEX's comments show that between March 1987, when the SEC established the 90-day goal for referrals, and June 1988, 57 percent of its 42 referrals were completed within 90 days. Additional information on the content and status of AMEX's enhancement projects is included in its comments in appendix III.

In addition, AMEX suggested that we include in the report information that it provided on referrals involving AMEX-traded options, along with the information on equity referrals. We included the information AMEX provided on page 42 of our final report.

The President of NASD said that NASD concurred with our recommendations. In particular, he supported our recommendation that SEC work with the SROs to establish a timetable for automating methods used to identify those who made suspicious trades.

CBOE reviewed the draft report but said they had no comments.

Comments From the Securities and Exchange Commission

Discussed on pp. 46-49

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

DIVISION OF
ENFORCEMENT

July 1, 1988

Richard L. Fogel
Assistant Comptroller General
General Government Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review the draft report entitled "Detecting and Prosecuting Insider Trading in Today's Global Securities Markets." The staff of the Divisions of Enforcement and Market Regulation, plus the Office of the General Counsel have reviewed the draft report. In general, there are no major problems with its content. However, we provided oral comments on June 23 and 24 to improve the accuracy of the report. Also, the Division of Market Regulation provided a comment by letter dated June 27, on the electronic "blue sheet" information and the "unusual activity" centralized database projects so that GAO will have information on the current status of these projects. We believe that the comments and information provided previously should be incorporated into the final report. Therefore, we will not be submitting written comments on the draft report.

If you have any questions, please contact Mr. Thomas Hamill at 272-2328 or me at 272-2230.

Sincerely,

John H. Sturc
Associate Director

Comments From the New York Stock Exchange

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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Richard A. Grasso
President and
Chief Operating Officer

NYSE
New York
Stock Exchange, Inc.

July 7, 1988

Mr. Richard L. Fogel
Assistant Comptroller General
U. S. General Accounting Office
General Government Division
Washington, D. C. 20548

Dear Mr. Fogel:

Thank you for giving the New York Stock Exchange the opportunity to review and comment on the draft report entitled: Securities Regulation: Efforts to Detect, Investigate, and Deter Insider Trading.

Discussed on p. 43.

The GAO's Report related to the NYSE's insider trading investigations for fiscal years 1985 and 1986. We believe that the Report accurately reflects the NYSE's then current and proposed surveillance programs. Its major criticism of all SROs is the length of time for referrals to the SEC. The NYSE, too, has been concerned about the length of time for insider trading investigations, and has taken several important steps which will accelerate the timeliness of referrals.

Discussed on p. 43.

In 1987, seventeen additional persons were added to the Exchange's staff involved in insider trading investigations. With the completion of training, this staff should reduce individual analyst's case load and lead to more expeditious completion of investigations.

Discussed on pp. 43 and 46.

An initial step in all investigations is obtaining from the broker-dealers, the names of all accounts which traded the security during the period under review. This includes not only retail customers, but all agency orders (including institutions) as well as broker-dealer proprietary and employees' transactions. In late 1986, the NYSE, in conjunction with the Securities Industry Association (SIA) and the SEC, began developing a format for the automated submission of trading information from broker-dealers ("electronic blue sheeting"). In September, 1987, NYSE systems were developed and broker-dealers began implementing the automated submissions. To date, 14 clearing firms have been submitting information electronically. This represents 61 NYSE member firms and a total of 212 broker-dealers. An additional 78 member organizations now have the ability to transmit electronically. We are working with the remaining member organizations in the development of their

See Comment 1.

Discussed on p. 45

systems. All have responded positively. A new NYSE rule requiring automated submission has just been approved by the SEC. We anticipate a substantial increase in electronic submissions by the end of the year.

Discussed on p. 33

In addition to obtaining and analyzing all trading information, and taking the investigatory steps outlined in the draft report, NYSE investigations also include, when appropriate, the taking of depositions from member organization employees, who were involved in the trading either directly or on an agency basis, or in the corporate development.

Discussed on p. 48

The NYSE has also developed an automated data base of names of individuals and institutions who have repeatedly appeared as trading prior to corporate announcements. We are working with the Intermarket Surveillance Group, founded in 1981 and comprised of the nine securities and options SRO's, to create and conduct coordinated intermarket surveillance, to apply this data base on an intermarket basis. These records had previously been maintained by the analysts in a manual fashion because "pattern" cases have resulted in the more significant cases brought by the SEC which were referred by the Exchange.

Discussed on p. 64

In addition, the SEC has recently approved the NYSE's "Regulatory Initiatives" rules' package. These rule changes codify, clarify and give specificity to supervisory and compliance obligations of members and member organizations. In general, the amended rules provide for the review of all employee and proprietary trading pursuant to procedures which must be reasonably designed to identify trades that may violate the prohibitions on insider trading and manipulation. If any trade appears to have violated any such law or rule, the member or member organization must promptly investigate the trade and submit written status reports to the Exchange. On a quarterly basis, the member, or officer or partner of a member organization must submit a statement to the Exchange specifying that procedures have been established and that, except as to trades which are the subject of an investigation, there is no reasonable cause to believe that any of the employee or proprietary trades effected during the quarter violated the statutory and rule provisions prohibiting insider trading and manipulation.

Discussed on p. 64

The amended rules also make it clear that, when the Exchange requests information from a member or member organization regarding trades, such information must be submitted by the date required by the Exchange. The Exchange may also levy a summary fine for failing to comply within the date specified. This provision, together with the development of automated "blue sheeting", should result in trading information being provided to the Exchange on a more timely basis.

Also, since the GAO's Report, the NYSE filed and the SEC approved an amendment to NYSE Rules which eliminates maximum fine schedules.

Discussed on p. 22

While these are some of the specific actions taken by the Exchange to improve the detection and investigation of insider trading, the NYSE continues to develop its automated systems to assist the analysts in their surveillance and investigative functions. The Automated Search and Match (ASAM) data base has been expanded to include names of lawyers, accountants and investment bankers. Automated trade data submissions are automatically matched against the ASAM investigative tree and "matches" are highlighted for the analysts. The Exchange is also exploring the application of artificial intelligence to the analytical stages of investigations.

Discussed on p. 64

The Exchange continues in its efforts to reduce the length of time of its investigations. Our staff continues to meet with SEC staff on a quarterly basis to discuss the status of referrals and other relevant issues. As a participant of the Intermarket Surveillance Group (ISG), it continues to work with other SROs to address other ways to expedite referrals. The Exchange continues to verbally refer, with a confirming letter containing specifics, those trades which have been identified, through analysis of participants to the trade, as potentially based on inside information. It is important to note that there has been some improvement, although more can be done. For example, the average age of referrals to the SEC involving insider trading investigations, based on the date the matter was verbally referred to the SEC, was 11 months in 1987, and 6 months for the first quarter of 1988. Our objective is to provide timely referrals, while maintaining the quality of our investigations and referrals. It is important to consider, when establishing goals, the volume of trading involved in an Exchange investigation, and the depth of analysis conducted by the NYSE staff as was seen in the cases reviewed by the GAO staff. Even as to verbal referrals, our referrals are not merely communications of a timely trade in itself, but includes an analysis which has led us to preliminarily conclude there could be insider trading.

We thank your staff for the work they have done and their professionalism in conducting their review. We ask that this letter be made a part of the GAO's Report to the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce.

Sincerely,

Richard A. Grasso

The following is GAO's comment on the New York Stock Exchange letter dated July 7, 1988.

GAO Comment

1. After the receipt of this letter, NYSE provided us with an updated status of the electronic blue sheet project. This information, which increases the number of member organizations who now are transmitting information electronically, has been incorporated on page 46 of the final report.

Comments From the American Stock Exchange

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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Richard O. Scribner
Senior Executive Vice President
Legal and Regulatory Affairs

American Stock Exchange

VIA FEDERAL EXPRESS

June 17, 1988

Mr. Richard L. Fogel
Assistant Comptroller General
United States General
Accouting Office
Washington, D.C. 20548

RE: Draft GAO Report --"Securities Regulation: Efforts to Detect, Investigate and Deter Insider Trading"

Dear Mr. Fogel:

This is in response to your letter of May 19, 1988 to Arthur Levitt in which you invite the American Stock Exchange to comment on the above captioned draft report. The Exchange welcomes this opportunity since the maintenance of effective systems for detection of insider trading is vitally important to assuring the fairness of and public confidence in our national securities markets.

The Exchange has carefully reviewed the GAO's draft report and generally agrees with its suggestions for improving surveillance for insider trading. As set forth below, we are ,however, extremely concerned about the methodology employed by the GAO in measuring both the timeliness and effectiveness of the Exchange's insider trading surveillance program. Furthermore, the Exchange believes that a complete and accurate analysis of its surveillance program must include reference to the timeliness of our referrals to the SEC subsequent to March 1987, when the SEC first advised the SROs of its desire to receive all insider trading referrals within 90 days of the announcement that triggered the investigation. Finally, technological enhancements to the Exchange's surveillance systems implemented in the 13 months since

Discussed on p. 42.

Discussed on pp. 64 and 65.

AMEX

Discussed on pp 42 and 43

representatives of the Amex and the GAO last met are relevant to any description of our insider trading surveillance program and, consequently, should be reflected in the GAO's final report.

1. Timeliness of AMEX Referrals - - 1985 and 1986

The Exchange agrees that rapid referrals from the Exchange to the SEC are critical to the Commission's insider trading enforcement program. To this end, the SEC has advised the Exchange's surveillance staff over the years that the Amex should promptly notify the Commission's Division of Enforcement by telephone: (1) whenever the Amex detects suspicious trading by a person having a known connection to either the issuer or to a person with inside information, or (2) whenever the Amex detects suspicious trading by a foreign person or firm. The Exchange has complied with these requests and, as noted below, some of the most significant Amex insider trading referrals to the Commission have initially been made in this fashion.

In the Anthony Franco/Crowley, Milner matter, for example, the Exchange's surveillance analysts noted a significant purchase of Crowley, Milner & Co. stock on the morning of June 12, 1985. This purchase was effected at a price of $41 per share, up more than 1 7/8 from the previous close. At 11:35 a.m. trading in the stock was halted and the company announced it was in negotiations to be acquired by OHC, a private investment company, for $50 per share. By 12:35 p.m. the same day, Exchange surveillance analysts had determined that Anthony Franco, a public relations consultant for Crowley, Milner & Co., had purchased 3,000 shares of Crowley stock earlier that day at $41 per share. (Our investigation also revealed that Mr. Franco was president of the Public Relations Society of America). At 12:40 p.m. the Exchange notified the SEC's Division of Enforcement by telephone of Mr. Franco's activity and his relationship to Crowley, Milner & Co. The Commission immediately launched an investigation into the matter and eventually charged Mr. Franco with trading on inside information. Mr. Franco settled the charges and agreed to a court order barring him from future violations of the antifraud provisions of the federal securities laws. In view of Mr. Franco's position as president of the Public Relations Society of America, the case received extensive press coverage.

The recent Sterling Drug/Hoffman La-Roche matter is another example of the efficacy of the telephone referral process. In this case, Hoffman La-Roche announced after the close of trading on January 4, 1988, that it planned to acquire all of Sterling's stock for $72 a share. On January 5, Sterling opened at 75 1/2, up more than $18 per

share from the previous close. During the course of January 5 and 6, the Exchange determined the identity of a number of foreign entities that had purchased Sterling options prior to the announcement and immediately informed the Division of Enforcement by telephone of this result of its investigation. With this prompt telephonic notification, the SEC was able to quickly contact the Swiss regulatory authorities who froze the affected accounts.

Discussed on pp 45 and 64

With the foregoing in mind, the Exchange finds it disturbing that the draft GAO report ignores telephone contacts and face-to-face meetings between the Exchange's surveillance staff and the Division of Enforcement in assessing the timeliness of the Exchange's insider trading surveillance program. On several occasions during March and April 1987, the Exchange discussed the proper methodology for determining the timeliness of its insider trading referrals with representatives of the GAO. At the conclusion of these communications, the Exchange was advised that the GAO report would contain some measure of the timeliness of Amex referrals on the basis of the earliest communication between the Amex and the SEC that identified a person or persons suspected of insider trading, irrespective of whether the contact was in writing or over the telephone. (See the attached copy of letter dated March 30, 1987, from William Floyd-Jones of the Amex to Thomas Bittman of the GAO for some background on these communications.) Nothwithstanding our dialogue on this subject, the draft report at page 71 states:

See Comment 1

> "SEC and SRO staff indicated that some matters are brought to the SEC's attention more quickly informally, sometimes over the telephone, and later followed by the formal written SRO case referral report. Our review of actual referrals and SRO records showed that such referrals were made, but we were unable to review the timeliness of these referrals because the SEC and the SROs did not always keep records of those referrals. Also, SEC Enforcement officials said that phone referrals generally do not provide enough data for SEC to proceed with an investigation. Therefore, they need the written reports in order to initiate an investigation." (Emphasis supplied.)

Discussed on pp 42 and 64

While SROs other than the Amex may not have made a record of telephone referrals to the SEC, the Amex did maintain these records, and provided them to the GAO during its inspection. The GAO, consequently, had the documents in its possession necessary to measure the timeliness of the Exchange's referrals on the basis of the earliest communication regardless of format. In addition, the assertion that SEC officials "need the written reports

AMEX

in order to initiate an investigation" is contrary to fact. As demonstrated by the two matters described above, the SEC can act on telephone calls from the Exchange. There is, accordingly, no logical reason for completely ignoring the Exchange's telephone referrals.

Discussed on pp. 41 and 42

We further note that the GAO's draft report contains no apparent reference to the 36 insider trading referrals from the Exchange's Options Surveillance Department during the two-year study period. Specifically, Table 4.1 at page 70 of the draft report indicates that the Exchange made a total of 76 insider trading referrals to the Commission during 1985 and 1986. This figure precisely corresponds to the number of SEC referrals made by the Exchange's Equities Surveillance Department as described at pages 22 and 23 of a preliminary GAO analysis received by the Exchange in May 1987. (A copy of the preliminary analysis is attached for easy reference.) Page 24 of the preliminary analysis, however, clearly states that the Exchange's Options Surveillance Department made an additional 36 insider trading referrals to the Commission during the subject time frame. In other words, the GAO inspection team found that the Amex had made a total of 112 insider trading referrals during the subject two year period, not the 76 referrals tabulated in the draft report.

Parenthetically, the preliminary GAO analysis of the Exchange's surveillance system also indicates that in that instance your inspection team was able to measure the timeliness of the Exchange's telephone referrals, as evidenced by the following passage:

> "Our review of these [options] referrals show (sic) that in 18 of the 36 cases, Amex -- either orally or in writing -- initially referred the matters within three months from the date of announcement. In only seven cases, did the referral occur six-months after the announcement date. It should be noted that 28 of these referrals were done initially by phone."

Discussed on p. 42

Since the Exchange believes that the GAO's analysis of its insider trading referrals as set forth in Table 4.1 of the draft report is inaccurate, we have reformulated Table 4.1 and Figure 4.1 to reflect the full state of facts:

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Calendar Years 1985 and 1986 1/

Number of Days	Amex Number	Amex Percent
1 - 90	24	20.2%
91 - 180	40	33.6%
181 - 270	32	26.9%
271 - 365	20	16.8%
over 365	3	2.5%
TOTAL	119	100.0%

2. Timeliness of Amex Referrals -- March 1987 to Present

Discussed on p. 65

As mentioned at the outset of this letter, the SEC's Division of Enforcement established the 90-day guideline for insider trading referrals in March, 1987. An up-to-date analysis of the Exchange's surveillance and investigative functions, therefore, should include a review of the Exchange's performance in the 14 months subsequent to the promulgation of this guideline.

Since March 1987, the Exchange has made 42 insider trading referrals to the SEC. The arithmetic mean referral time for these matters was 87 days from the date of the announcement triggering the study to the date that the SEC was advised of the identity of suspected insider traders. The chart that follows shows that more than half of the Exchange's referrals occurred within the 90 day guideline, and that no referral required more than 270 days.

March 1987 to Present

Number of Days	Amex Number	Amex Percent
1 - 90	24	57.2%
91 - 180	14	33.3%

See Comment 2

1/ The GAO inspection team reviewed the Exchange's insider trading referrals for calendar years 1985 and 1986, not fiscal years 1985 and 1986 as stated in Table 4.1.

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181 - 270	4	9.5%
271 - 365	0	0%
over 365	0	0%
Total	42	100%

Discussed on p. 64.

The foregoing clearly demonstrates a significant improvement in the timeliness of Exchange insider trading referrals over the period covered by the GAO's staff.

See Comment 3.

3. Recent Technical Enhancements

The draft report mentions several surveillance systems that were under development or in the discussion stage at the time of the GAO's inspection of the Exchange. Since more than a year has passed between the completion of the inspection and our receipt of the draft report, we are providing you with a brief update on the status of these projects:

a. SWAT II. In 1983, the Amex installed the SWAT system. SWAT was the first real time surveillance system that could detect unusual activity in individual Amex equities based upon the unique trading characteristics of the particular security. In 1987, the Amex completed the hardware and software upgrades of its SWAT system (called SWAT II) that were described in the draft report.

b. Speech Plus/News Alert. The Speech Plus/News Alert system has been fully implemented. This system monitors the news wires for any stories pertaining to an Amex traded stock or option and it advises the surveillance staff when such stories appear. Speech Plus/News Alert frees the surveillance staff from the tedious monitoring of news services and allows them to focus on investigative work.

c. Automated Record Keeping (ARK). The Exchange now records all reports, analyses and memos regarding its stocks in an electronic filing system so that this information can be rapidly recalled as it is needed.

d. Unusual Activity File. Working under the auspices of the Intermarket Surveillance Group, eight national securities exchanges and the NASD are developing a "cumulative/

AMEX

comparative" database to store account names and other information regarding customers that traded prior to news. This system will be used to spot possible cross market patterns of insider trading. The SROs now are in the process of downloading information from their records into the Unusual Activity File.

Discussed on p. 46.

e. Electronic Blue Sheets. SEC approval of the Amex and NYSE electronic blue sheet rule filings is imminent. Fifteen clearing firms (representing the trading of more than 115 broker-dealers) are ready to electronically submit customer and surveillance information to the Amex and NYSE.

Conclusions

The Exchange believes that it has implemented an effective system for detecting and investigating possible instances of insider trading. This is evidenced by, among other things, the Exchange's progress toward reaching the SEC's 90-day referral guideline and by the prior successes of the Exchange's insider trading surveillance program.[2/] We therefore believe that the GAO's draft report inaccurately evaluated the efficacy of the Exchange's surveillance and investigative systems, in part because it generally discussed SRO insider trading surveillance as fungible between markets, and also because of the several flaws in the GAO's methodology discussed in the body of this letter. Notwithstanding the foregoing, the Exchange generally agrees with the draft report's suggestions for a SEC role in developing a timetable for the implementation of electronic blue sheeting, emphasis on negotiations between

See Comment 4.

2/ One-third of all criminal prosecutions for insider trading in the Southern District of New York during the years 1980 through February 1986 resulted from Amex referrals. (See the attached list of prosecutions compiled by the New York Law Journal. Cases resulting from Amex referrals are marked with asterisks.)

AMEX

U.S. and foreign regulators to facilitate information sharing and the GAO's suggestion that foreign financial institutions disclose the size of their customers' trading. The Amex is committed to improving its insider trading surveillance programs, and believes that the implementation of these suggestions would further enhance our efforts.

We appreciate the opportunity to comment on the GAO draft report.

Very truly yours,

See Comment 5

cc: Thomas C. Bittman

Enclosures

AMEX

The following are GAO's comments on the American Stock Exchange letter dated June 17, 1988.

GAO Comments

1. In our evaluation of the age of AMEX's referrals, we used only the written referral dates. We did not use the phone referrals because (1) SEC said phone referrals generally do not provide enough information to determine whether to proceed with an investigation, and (2) we could not verify the accuracy of the phone referral data since SEC did not maintain records of phone referrals. However, information on phone referrals and how they affected AMEX's timeliness, which was provided by AMEX in its comments, has been included on page 42 of the final report.

2. Table 4.1 on page 41 was revised to show that the referral information obtained was for calendar years 1985 and 1986.

3. By reference to AMEX's letter at page 63, we have incorporated these recent technical enhancements in the final report.

4. As stated on page 18 of our report, we did not evaluate the effectiveness of the SRO's surveillance systems. Although we agree that the SROs' systems differ in some respects, we believe that sufficient similarities exist to allow them to be discussed in aggregate. SEC expects all SROs to make timely referrals to the SEC. In this regard, AMEX's comments about our methodology for determining the timeliness of its referrals, namely our use of written communications rather than telephone, are addressed on pages 42 and 64.

5. We did not include the enclosures in appendix III of this report.

Comments From the National Association of Securities Dealers

NASD

National Association of Securities Dealers, Inc.
1735 K Street N.W.
Washington, D.C. 20006
(202) 728-8000

June 30, 1988

Richard L. Fogel
Assistant Comptroller General
General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

Thank you for the opportunity to comment on the draft report prepared by the Government Accounting Office entitled Securities Regulation: Efforts to Detect, Investigate, and Deter Insider Trading. We have carefully considered it and concur with its recommendations.

As you may know, the NASD, as a self-regulatory organization has been concerned for some time with the abuses of insider trading in the marketplace. As a result, we have initiated special efforts to enhance our ability to detect, investigate and deter insider trading in non-exchange listed securities. In the course of these efforts, we have been confronted with many of the investigatory road blocks and delays described in the draft report. In this regard, we particularly support the report's recommendation that "the SEC Chairman, in conjunction with the SROs, establish a timetable for automating methods used to identify those who made suspicious trades." Further, your recommendations concerning paying informants for information concerning insider trading and for the SEC to strengthen negotiations with other countries for the release of information on suspicious trades executed through foreign financial institutions are certainly well taken and, if implemented, should be very fruitful.

If there is anything further we can do to assist in the endeavor, please let me know.

Very truly yours,

Joseph R. Hardiman
President

JRH/zkf

Comments From the Chicago Board Options Exchange

The Chicago Board Options Exchange

Arne R. Rode
General Counsel

LaSalle at Van Buren
Chicago, Illinois 60605 312 786-7400

June 20, 1988

Mr. Craig Simmons
United States General Accounting Office
Room 3858 C
441 G Street; N.W.
Washington, D.C. 20548

Dear Mr. Simmons:

I and members of CBOE's surveillance department have reviewed your draft report entitled Securities Regulation: Efforts to Detect, Investigate, and Deter Insider Trading. CBOE has no comments on your report. Thank you for giving us the opportunity to review it. Returned herewith, is the copy sent to me. I am advised that all other copies have been destroyed.

Sincerely yours,

Arne Rode

ARR/nk
encl.

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